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Recent Decisions and Administrative Rulings

By HARRY KATZ

THE ever continuing quest for certainty in the law has recently yielded, in the field of New York City excise taxes, several decisions worthy of note. While these holdings have resolved only some of the numberless problems which arise constantly in the administration of these different taxes, they should be of considerable aid in assisting both the taxpayer and the tax administrator in the correct application of the law.

When may a local tax be levied with respect to interest on bank accounts outside the City? When is an interstate shipment of goods subject to the taxing power of the City? What is the tax status of transactions between parent and subsidiary corporations?

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This paper was presented by Mr. Katz at a technical meeting of the Society held at the Engineering Societies' Building on May 17, 1949, under the auspices of the Committee on Municipal and Local Taxation.

These and others are some of the interesting problems which were submitted to the courts for decision during the past year or two, and which have been the subject of judicial determination. Tonight, I propose to discuss four court decisions and one administrative ruling which cover these and similar matters. As it happens, the decisions and the ruling which I will review cross four of the City's tax laws—the Utility Tax, the Gross Business Tax, the Sales Tax and the Compensating Use Tax. You will thus be afforded a fair view of the impact of these different taxes on the varying types of business transactions and activities which take place daily in the City of New York.

The *New York, Ontario & Western Railway* case (161 F. 2d 518), which was decided by the United States Circuit Court of Appeals in 1947, involved a number of these problems. This railroad, a New York corporation, operated several railroad lines outside the City; none of them came into the City. In the course of a proceeding for reorganization of the railroad pending in the federal court, the City filed a claim for utility taxes on different items of gross income received by the railroad from various sources. One of these

items was interest income derived from balances maintained in banks outside the City, one of the banks being located in Montreal, Canada. The trustees of the railroad opposed such application of the tax, contending that it would violate the Commerce Clause of the federal constitution because the bank deposits upon which this interest was earned resulted from interstate commerce. They argued further that there was no jurisdiction to levy the tax on this item because the interest in question never came into the City. The facts showed that the principal office of the railroad was in New York City, that its directors' meetings were held here, that its main books of account in which the interest was entered were kept here. It further appeared that the interest was disbursed by the railroad in the ordinary course of business by checks drawn in the City of New York by its officers present here. On the basis of these facts the court held that the tax was validly levied on interest received by the railroad on its out-of-City bank balances.

The relation between bank and depositor is that of debtor and creditor; a bank balance thus represents an intangible asset. Such an asset may be taxed at the place where its owner, the depositor, maintains its commercial domicile. In the case under consideration, the activities of the railroad taking place in New York City, which have just been briefly reviewed, were sufficient to establish that it plainly had a business domicile here. Accordingly, its bank accounts could be taxed locally.

Another important question—one of first impression—which was presented in the same case was whether the City could tax the gross receipts of the railroad from demurrage on freight shipments which had travelled interstate. Demurrage was earned by reason of the delay of consignees in unloading these shipments from the freight cars within 48 hours after arrival at a local terminal here. The full amount of the demurrage charge was collected in the first instance by the terminal company, which then remitted a portion of such charge to the railroad and retained a part for its own services, in accordance with demurrage tariffs filed with the Interstate Commerce Commission. The trustees of the railroad argued that demurrage represented an integral and essential part of interstate transportation which was exempt from local taxation under the Commerce Clause. The City maintained that demurrage receipts represented gross income resulting from a local activity separate and distinct from interstate transportation. The court decided that demurrage was not a necessary part of the transportation of goods, but arose only after transportation had ended and the property had finally come to rest. Accordingly, the tax on these receipts was sustained.

It should be noted that the court distinguished the case before it from the *Carter and Weekes* decision previously handed down by the United States Supreme Court (330 U.S. 422). In the latter case, the City gross business tax had been held invalid as applied to the earnings of local stevedores who loaded and discharged cargoes of vessels moving in interstate and foreign commerce. While the activities of the stevedores in that case were held to be indispensable to the actual process of transportation, the Court declared that the same thing could not be said concerning demurrage, which was in substance a charge for detention of the freight cars and not a charge for transportation, even though the interstate carrier itself became entitled to receive a portion of such charge.

The decision on this question points up the distinction between interstate commerce immune from local taxation, and an activity which, though related in some way to the commerce, is thought to be sufficiently disjoined from it to permit local taxation. The distinction is not always a plain one. The law is nevertheless established that exemption from taxation will not be granted

solely because some relation to interstate commerce exists; the connection with the commerce must be a direct and essential one, and not merely incidental to it.

The final matter I will take up in this diverse case involved still a different issue—the taxability of transactions between affiliated corporations. The factual background was this: the railroad was sole owner of three subsidiary roads which operated as part of its system. None of the subsidiaries had any rolling stock; the property of each was limited to its physical rights of way and the improvements thereon. The subsidiaries issued bonds, all of which were held by the parent. The lines of the subsidiaries were leased to the parent which was obligated to pay rent therefor in the same amounts and at the same times as interest was payable on the bonds of the subsidiaries held by the parent. The City's claim included tax to the parent on the amount of interest on these bonds. The trustees contended that the subsidiaries were merely departments of the parent under its absolute control, that the source of the interest was the parent railroad itself, and that the rent and the interest were purely artificial items which did not represent taxable gross income. The court over-ruled this contention, saying that the existence of the subsidiaries as separate corporate entities could not be ignored. For tax purposes, so long as the transactions of a corporate entity are equivalent to the conduct of business activity, the existence of separate corporations could not be denied recognition.

This is not a novel doctrine. In tax cases generally, the courts are not concerned with the purpose underlying the conduct of business through the medium of affiliated corporations. That the motive is not the realization of tax benefits is immaterial. So long as a corporate being fills a useful purpose in business life, whatever the purpose may be, it constitutes a separate taxable entity, and its corporate existence cannot be explained as being merely a fiction.

The same principle was implicitly applied to transactions between affiliated companies in still another case decided during the past year—the *New York World-Telegram* case (272 App. Div. 806, reversed 298 N.Y. 11). The question there presented was whether a transaction entered into between a parent and its wholly owned subsidiary represented a lease or a conditional sale of personal property. Either type of transaction is subject to tax under the sales tax law. But because in this case delivery of the property which was the subject of this long-term arrangement between the two corporations took place before the sales tax law was originally enacted in 1934, the question of taxability hinged on the nature of the particular agreement between the two corporations. You will recognize from this that, fundamentally, the case involved an interpretation of the contractual relationship between the parent and its subsidiary, and not a construction of the tax law. Indeed, there was no substantial dispute between the taxpayer and the city concerning the meaning of the tax law. The Court of Appeals held the transaction to be a non-taxable conditional sale and not a lease of property subject to tax. In doing so, it reversed the decision of the Appellate Division. While the two courts arrived at precisely opposite conclusions concerning the nature of the transaction between the parties, evidently neither felt that the transaction derived any immunity from the fact that the subsidiary was the *alter ego* of the parent corporation. In fact, the claim originally put forward by the taxpayer that its subsidiary should not be regarded as a separate entity for the purpose of the tax was ultimately abandoned by it.

A somewhat different type of situation where a transaction was alleged to be a fictitious one, hence not within the scope of the tax, occurred in the *Realty Associates* case (274 App. Div.

926), decided in November 1948. In that case a gross business tax deficiency was assessed, among other things, upon interest received by the taxpayer on its own bonds held in its treasury. The taxpayer had acquired these bonds in over-the-counter transactions for the purpose of investment or resale, and not for retirement. The City claimed that interest received by the taxpayer on these bonds represented taxable income in the same way as would interest received by the taxpayer from investment in the securities of other corporations. The court confirmed the assessment without writing an opinion. In effect, therefore, its holding is that a corporation's transactions and dealings in its own securities yield income or profit taxable to it under the City business tax law. In the field of federal taxation, this principle has been established for many years; it was, in fact, reaffirmed only last January by the United States Supreme Court in *Commissioner* v. *Jacobson.*

The *Fifth Avenue Building* case (297 N.Y. 278), decided last year, represented virtually an attempt by the taxpayer to reargue the Supreme Court holding in the *Berwind-White* case handed down in 1940. That decision held that a sale of goods which were delivered in the City after crossing state lines was not exempt from the City sales tax. In the *Fifth Avenue Building* case, a sales tax deficiency had been assessed against a purchaser of coal which was shipped from the vendor's West Virginia mines and delivered to the purchaser at a dock in New York City. The taxpayer contended that this sale was not taxable because made in interstate commerce. Upon review by the court, the established principles of the *Berwind-White* case were adhered to and the validity of the tax was upheld as applied to the transactions in question. The sale, the court declared, was consummated by delivery of the coal to the purchaser in the City of New York. This represented a local incident taking place here which justified the imposition of the tax, even though just prior to such delivery the coal had been moving interstate.

A subsidiary issue in the same case, which related only to part of the assessment, raised a question concerning the interpretation of the Sales Tax Law. The assessment against the purchaser of the coal covered the period from 1934 to 1942. The vendor had been previously audited by the City for the years 1934 to 1940, and upon such audit it was disclosed that no sales taxes had been collected by it from the purchaser during the period. As a result of the audit, the vendor paid to the City the taxes due on these sales. Some time afterward, the purchaser repaid its vendor for the amount of these taxes for the years up to 1937, but failed to pay for the ensuing period. In making the assessment against the purchaser, the City gave it credit for the taxes paid to its vendor for the years 1934 to 1937. However, the sales taxes for the years 1937 to 1940, which the purchaser at no time had paid either to its vendor or to the City, were included in the amount of the deficiency assessment.

The question was whether, under the circumstances described, the provisions of the Sales Tax Law authorized the City to collect the tax from the purchaser for the years 1937 to 1940. Parenthetically, I want to make the observation that the City was not here seeking to collect two taxes upon the same sales—one from the vendor, the other from the purchaser. For if the City were successful in collecting the tax from the purchaser in this case, the vendor had a remedy to obtain reimbursement from the City for the amount of taxes paid by it on these transactions. Quite simply, it was the position of the City that under the express provisions and the whole scheme of the Sales Tax Law, the tax was imposed primarily upon the purchaser, and the vendor was prohibited from absorbing the tax. The underlying purpose of this was to prevent some

vendors from obtaining an unfair competitive business advantage over others by not collecting the tax but, instead, absorbing it themselves. The decision of the court on this part of the case went in favor of the taxpayer, the court holding that to the extent that the City had collected the tax from the vendor, it could no longer proceed against the purchaser. In view of this holding, it would appear that under circumstances similar to those present in the *Fifth Avenue Building* case, i.e., where the vendor has paid the tax to the City, the sales tax liability of the purchaser can be enforced only by means of an action brought against him by the vendor to recover taxes paid by the latter. The decision points out that under the law vendors who wilfully fail to charge and collect the tax may be subjected to criminal penalties.

A further comment is in order concerning the holding on this phase of the *Fifth Avenue Building* case. It should be noted that the court's ruling rests on a record which shows that the purchaser had adduced affirmative proof—which was at no time controverted—that his vendor had paid the tax in full on the transactions in question. The purchaser had thus met the burden cast upon him by the tax law of showing that the receipt was not subject to tax. Therefore, in any situation where a purchaser, under the holding of this case, seeks to be absolved by reason of a tax payment claimed to have been made by his vendor, it is incumbent upon him to submit satisfactory proof to substantiate such claim.

The ruling which I propose to discuss this evening is Bulletin 1948-1, promulgated November 5, 1948. This ruling deals with the liability of a vendor to collect the compensating use tax on the sale of tangible personal property to a New York City customer who takes delivery outside the city. As you are aware, the use tax was enacted as a complement to the sales tax and applies in general to the use in the City of goods purchased outside by New York City residents. Under the Use Tax Law every vendor maintaining a place of business in the City and making sales of tangible personal property, the use of which is taxable under the law, is required to register with the City and to charge and collect the tax upon taxable transactions in generally the same way as are vendors under the Sales Tax Law.

You can appreciate the fact that in some circumstances a vendor who delivers goods to a New York City resident outside the City may not have any knowledge of the eventual destination of the goods or whether they will be used by the purchaser in New York City. Such vendor is consequently in the position of not knowing at the time of sale whether or not the use tax should be collected from the purchaser. In these circumstances, Ruling 1948-1 removes from him the responsibility of making a determination as to whether a particular transaction is or is not subject to the use tax. It does this by absolving such vendor from the obligation of charging and collecting the tax, provided, however, he does either of two things: (1) he obtains a written statement from the purchaser that the latter has arranged or will arrange for transportation of the goods to a point outside New York City, or (2) he obtains a written statement from the purchaser that the latter has retained or will retain the property in his own storage facilities outside the City or otherwise has used or will use the property outside the City.

Where the vendor obtains a certificate from the purchaser to this effect, he will not be held liable for failure to collect the use tax even though his New York City customer should subsequently use the property in New York City. If the property is thereafter used in the City, the obligation of reporting and paying the tax is placed squarely upon the purchaser of the goods who is required to file a return and pay the tax directly to the City. It

(Concluded on page 483)

Determination of When Sales or Services Are Wholly Taxable, Non-Taxable or Allocable, and An Analysis of All Formulas

By Bertram L. Steinberg, C.P.A.

Many times in the past, in discussions with accountants, when the question of allocation of interstate commerce was mentioned, the accountants would say, "It doesn't pay to spend the time necessary to make the allocation." When the business tax rate was 1/20th of 1%, and the amount of tax saving involved on a million dollars in allocable sales would be approximately $333, this was probably true. Practical accountants would include these allocable receipts as wholly taxable receipts in order to avoid the task of analyzing several million dollars of receipts. However, with the current rate of 1/5th of 1%, the tax saving on this same million dollars of allocable sales is approximately $1,333, and the difference is of sufficient importance to cause accountants to study very carefully the allocation provisions of the General Business and Financial Tax Law and the Comptroller's Regulations.

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This paper was presented by Mr. Steinberg at a technical meeting of the Society held at the Engineering Societies' Building on May 17, 1949, under the auspices of the Committee on Municipal and Local Taxation.

In any discussion of this question of allocation and, particularly with respect to the allocation formulas adopted by New York City in the administration of its Gross Receipts Tax Law, it is necessary to first trace the history of apportionment of taxes. Today, apportionment is generally said to be necessary to validate a tax based upon gross receipts from interstate transactions, although, where the tax is based upon some local event, though connected with the commerce, it may be sustained without allocation. See, e.g., *Western Live Stock* v. *Bureau of Revenue*, 303 US 250, with which compare *Fisher's Blend Station* v. *State Tax Commission*, 297 US 650, and *McGoldrick* v. *Berwind-White Coal Min. Co.*, 309 US 33.

Formerly, interstate commerce was clothed with complete immunity from local and state taxation, but the discrimination against local business in favor of interstate commerce soon led to the realization that even interstate business must pay its way. Having reached this decision, the Supreme Court of the United States was faced with the difficult problem of according to the states the power to tax, while retaining for Congress its constitutional right of regulating commerce between the states.

In working out a solution to this problem, the Supreme Court of the United States laid down the following rationale:

(1) Persons doing business in, or connected with, interstate commerce are not immune from all taxes on their gross receipts.

(2) Such taxes are invalid under the Commerce Clause only if they discriminate against interstate commerce or result in the possibility of cumulative multiple tax

burdens merely because interstate commerce is being done.

(3) The possibility of cumulative multiple tax burdens is avoided as to such taxes by basing the tax either upon some essentially local event which cannot be repeated in another taxing unit, or upon an allocated portion of the gross receipts fairly commensurate with the business done in the taxing jurisdiction.

Of the many cases which have reached the Court on the question of local taxation of interstate commerce, many establish the principle that a tax on gross receipts would be upheld where the taxing statute prescribed a fair allocation. See, e.g., *Illinois C. R. Co.* v. *Minnesota*, 309 US 157; *Wisconsin & M. R. Co.* v. *Powers*, 191 US 379.

Still another group of cases upheld a gross receipts tax on a "local incidence theory." Here the Court stated that, where the local business was distinct from interstate commerce, it might be made the condition of state taxation. See, e.g., *Western Live Stock* v. *Bureau of Revenue*, 303 US 250; *McGoldrick* v. *Berwind-White Coal Min. Co.*, 309 US 33.

However, it was also held in a group of cases that a tax on gross receipts from interstate commerce would not be sustained where the receipts might be subject to the risk of multiple taxation because not apportioned, or where the incident taxed was not a local one. See, e.g., *Philadelphia & S. Mail S. S. Co.* v. *Pennsylvania*, 122 US 326; *Adams Mfg. Co.* v. *Storen*, 304 US 307; *Gwin, White & Prince* v. *Henneford*, 305 US 434.

Thus, we find that the Court, in indicating which taxes on interstate commerce violate the Commerce Clause, stated in the *Western Live Stock* case, *supra*, as follows:

> "The vice characteristic of those (taxes on gross receipts from interstate commerce) which have been held invalid is that they have placed on the commerce burdens of such a nature as to be capable in point of substance of being imposed * * * or added to * * * with equal rights by every state which the commerce touches, merely because interstate commerce is being done, so that, without the protection of the commerce clause, it would bear cumulative burdens not imposed on local commerce. * * * The multiplication of state taxes measured by the gross receipts from interstate transactions would spell the destruction of interstate commerce and renew the barriers to interstate trade which it was the object of the commerce clause to remove."

When the City Gross Receipts Tax Law was enacted in 1938, following the *Western Live Stock* decision, the Comptroller was given the right "to prescribe methods for determining allocations of receipts to the city." Pursuant to this authority, the Comptroller prepared formulas calculated to avoid multiple taxation and to tax only an aliquot part of receipts from interstate commerce reasonably attributable to the doing of business in the City of New York.

Before discussing these formulas and the types of receipts which enter into their computation, let me first mention the receipts which are not involved in it. They are receipts from foreign commerce, and certain so-called non-allocable and non-taxable receipts.

Foreign Commerce

The Comptroller's Regulations permit foreign commerce as a deduction in computing the measure of the tax. Foreign commerce includes not only all forms of trade or commercial activity between the United States and foreign countries, but *also trade between the United States and its possessions.* This exemption also covers receipts from the sale of imports by the importer thereof when sold in the original unbroken package or container in which the goods were imported (i.e., the overall package or container). The exemption, however, does not apply where the imports are sold other than in the original unbroken package or container, nor to receipts from the sale of imports by any person other than the importer.

Certain local services, however, connected with foreign commerce, but yet not an integral part of such commerce,

do not enjoy the exemption accorded foreign commerce transactions:

(a) A ship building company located in New York City constructs or repairs vessels that are to be employed in traffic betwen the United States and foreign countries.

(b) A ship's chandler located in New York City who sells materials and supplies to steamship companies in New York City for use by steamships which are operated in foreign commerce exclusively.

(c) A custom house broker in New York City who secures licenses and clearances for export shipments to foreign ccuntries.

Non-Allocable and Non-Taxable Receipts

Non-allocable and non-taxable receipts are receipts which arise from sales transactions where both the shipping of the goods and the delivery thereof to the purchaser take place entirely outside the territorial limits of the City of New York. Thus, receipts from sales made by a New York City vendor involving the shipment of goods from his own factory or warehouse situated outside the City to the purchaser at a point located outside the City, whether within or without the State of New York, are deemed to be non-allocable and non-taxable receipts.

Other examples of non-allocable and non-taxable receipts include:

(1) Receipts of persons operating transportation facilities where such receipts from intrastate and interstate traffic neither originate nor terminate within the City of New York and is consummated wholly outside the territorial limits of the City. (Article 213, Comptroller's Regulations)

(2) Receipts from industrial services performed wholly outside the City of New York and rendered to customers outside the City. (Article 225, Comptroller's Regulations)

(3) Receipts from the rental of tangible personal property, as follows:

  (a) If the original situs of the property is within the City of New York, but the property is delivered to lessees outside the United States, including the territories and possessions of the United States.

  (b) Where the original situs of the property is outside the City of New York, and the property is delivered to lessees outside the City of New York, whether within or without the United States. As used above, the term "original situs" means the point at which the property is warehoused when not leased to others, and to which point the property is returned upon termination of the lease. Where there is no such established point, the term "original situs" shall mean the principal office of the taxpayer. (Article 249, Comptroller's Regulations)

I will now discuss the several kinds of allocation formulas adopted by the Comptroller.

Regular Allocation Formula

As previously stated, since the enactment of the 1938 Gross Receipts Tax Law, the Comptroller has been empowered to establish rules and regulations and methods of allocation and evaluation so that the City of New York, as a result of such allocation, receives an aliquot part of receipts resonably attributable to the doing of business in the City of New York. The formula for determining the percentage of interstate commerce receipts subject to tax by New York City is based upon the average of three factors, as follows:

(1) The property factor, which is the percentage of the average value of real and tangible personal property employed in business within the City of New York to the total average value of all such property employed in business within and without the City of New York, but within the United States.

(2) The wages and salary factor, which is the percentage of the total amount of wages, salaries and other personal service compensation paid during the basic period to officers and employees who work in or from or are attached to places of business located within the City of New York to the total amount of all services, salaries and other personal service compensation paid to all officers and employees engaged within and without the City of New York, but within the United States.

(3) The receipts factor, which is a percentage computed by taking the wholly taxable receipts plus ⅓ of the allocable receipts and dividing that sum by the total of all wholly taxable and allocable receipts.

The average of these three percentages, where more than 33⅓% or less than 66⅔%, is the percentage of allocable receipts allocated to the City of New York and subject to the full rate of tax. Where the percentage is greater than 66⅔%, it is to be reduced to 66⅔%, and, where the percentage obtained is less than 33⅓%, it is to be raised to 33⅓%. In other words, at least ⅓, and no more than ⅔ of all receipts subject to allocation are to be included as allocated receipts upon which a tax is due.

This regular allocation formula, however, had the effect of discriminating against New York City manufacturers, and it soon became necessary to make an adjustment. This was done by evolving an alternative formula applicable to New York City manufacturers.

Alternative Allocation Formula Applicable to New York City Manufacturers

This alternative formula became effective with the filing of the gross receipts return pursuant to Local Law #103 of 1939, due June 15, 1940. A manufacturer engaged in manufacturing, fabricating or producing goods within the City of New York was permitted to elect to file on the basis of the cost of manufacturing and selling goods shipped in interstate commerce.

The term "manufacturer" includes a person who, either directly or by contracting with others for the necessary labor or mechanical service, manufactures, fabricates or produces for sale or commercial use *from his own materials or ingredients* new or different articles, substances or commodities. A person will be deemed to be engaged in manufacturing within the City of New York and entitled to use the alternative formula only if he fits within one of the following categories:

(1) Where the entire manufacturing or fabricating process is performed at a plant owned or operated by the manufacturer within the City of New York, and the finished goods are shipped to customers from the City.

(2) Where a part or the entire manufacturing or fabricating process is performed at a plant owned or operated by the manufacturer outside the City of New York, and the finished goods are returned to the City from which point shipment is made to customers.

(3) Where the manufacturer purchases the raw materials and supplies, but "farms out" a part or the entire manufacturing or fabricating process to a contractor, and the finished goods are returned to the manufacturer in the City, from which point shipment is made to customers.

(4) Where the manufacturer causes delivery to be made directly from the contractor's premises located outside the City of New York. The receipts are wholly taxable if delivery is made to a purchaser located within the City of New York, and are non-allocable and non-taxable if delivery is made to a purchaser located outside the City of New York.

The portion of receipts from sales in interstate commerce to be allocated to the City of New York under this alternative formula shall be an amount equal to 50% of the cost of manufacturing and selling the goods shipped from the City in interstate commerce, subject to the limitation that such cost shall not exceed 66⅔% of the receipts from such sales. The amount of receipts so allocated to the City of New York plus the amount of wholly taxable receipts are to be included in the measure of the tax.

The words "cost of manufacturing and selling," as used herein, shall include the cost of materials and supplies consumed, factory labor, contractor labor, factory overhead, processing expenses, advertising expense, salaries, commissions and traveling expenses of sales personnel, salaries and wages of shipping and delivery personnel, shipping and delivery expenses, and any other costs or expenses incurred in manufacturing and selling the goods shipped in interstate commerce.

Allocation Formula Applicable to Transportation Receipts

Operators of transportation facilities not otherwise subject to the provisions of the Utility Tax Law are subject to the General Business and Financial Tax Law. Included in this category are the following:

(1) Persons transporting property by motor vehicle who are specifically exempt under the Public Service Law of the State of New York from supervision of the State Department of Public Service.

(2) Persons operating air lines.

(3) Persons operating steam ship lines.

(4) Persons operating fleets of taxi cabs.

Such persons as those above, who operate transportation facilities both within and without the City of New York, whether in intrastate or interstate commerce, are required to make an allocation of receipts based upon the following three factors:

(1) The mileage factor, which is the percentage of the number of linear route miles within the City of New York to the total number of linear route miles of routes originating and terminating within the City and wholly within the United States. In computing with respect to steam ships or vessels operated over regularly scheduled routes, the linear route miles within the City of New York shall mean "within the territorial waters of the City of New York." Where a taxpayer does not operate transportation facilities over regularly scheduled routes, and cannot ascertain the total linear route miles over which such transportation facilities were operated within the City and within the United States, then such taxpayer may eliminate the mileage factor when computing the average of the percentages in making the allocation mentioned above.

(2) The wage and salary factor, which is similar to that in the regular allocation first discussed.

(3) The receipts factor, which is a percentage computed by taking the wholly taxable receipts plus ⅛th of allocable receipts and dividing that sum by the total of all wholly taxable and allocable receipts.

The average of these three percentages, where more than 12½% or less than 66⅔%, is the percentage of allocable receipts allocated to the City of New York and subject to the full rate of tax. Where the percentage is greater than 66⅔%, it is to be reduced to 66⅔%, and, where the percentage obtained is less than 12½%, it is to be raised to 12½%. (Article 213, Comptroller's Regulations)

Allocation Formula Applicable to Industrial Services

Where a person is engaged in rendering industrial services both within and without the City of New York, in connection with which such person maintains established places of business both within and without the City, such person may make an allocation of the receipts from industrial services on the basis of the property, wages and salaries and receipts factors. Industrial taxpayers permitted to make an allocation hereunder include, among others, persons engaged in dyeing, fabricating, manufacturing or otherwise processing articles of trade or commerce belonging to others, in connection with which a factory, plant or other establishment is maintained outside the City for the purpose of performing in whole or in part the industrial services for which a charge is made. The average percentage of the three factors is obtained in exactly the same way as described previously in connection with the regular allocation formula. In determining wholly taxable sales and allocable sales, the following should be observed:

(A) Wholly taxable receipts are receipts from industrial services performed wholly within the territorial limits of the City of New York and rendered to customers located within the City.

(B) Allocable receipts include either receipts from industrial services performed partly within and partly without the City of New York, or wholly without the City of New York, and rendered to customers located within the City, or receipts from industrial services performed partly within and partly without the City of New York, or wholly within the City, and rendered to customers located outside the City.

In computing the allocated receipts subject to tax, the total of all allocable receipts is to be multiplied by the average of the three percentages. Where

the resultant average of the percentages exceeds 66⅔%, it shall be reduced to 66⅔% for the purpose of allocation. Where the resultant average of the percentages is less than 33⅓%, it shall be increased to 33⅓%. (Article 225, Comptroller's Regulations)

Allocation Formula Applicable to Receipts from the Rental of or License to Use Tangible Personal Property

Persons doing business within the City of New York having title to tangible personal property which is leased to others are required to report the gross receipts from the rental of or license to use such property, in accordance with the following rules laid down by the Comptroller:

(1) Where the original situs of the property is within the City of New York, the receipts from tangible personal property leased to others are deemed to be:
   (a) Wholly taxable where the property is delivered to lessees within the State of New York.
   (b) Allocable where the property is delivered to lessees outside the State of New York, but within the United States.

(2) Where the original situs of the property is outside the City of New York, the receipts from tangible personal property leased to others are deemed to be allocable where the property is delivered to lessees within the City of New York. In allocating these receipts, the property, wages and salaries, and receipts factors are to be used to arrive at a percentage. A maximum percentage of 66⅔% and a minimum percentage of 33⅓% is to be used to determine the allocated receipts. In determining the allocated receipts, the total of the allocable sales is to be multiplied by the percentage obtained as previously described. (Article 249, Comptroller's Regulations)

Allocation Formula Applicable to Radio Broadcasting Receipts

A person operating radio broadcasting stations either within the city of New York or outside the City of New York, but in connection therewith maintains offices and/or studios within the City, is subject to the General Business and Financial Tax Law.

To determine the amount of receipts from the sale of sponsored time which is to be allocated to the City of New York, an allocation is permitted. This allocation, however, is permitted only with respect to the sale of time, and not with respect to the sale of auxiliary services performed within the City of New York, such as charges for special "hook-ups" to the main network, charges for the use of a house orchestra, charges for sound effects, etc.

The gross receipts from the sale of sponsored time with respect to stations having New York City call letters are required to be reported as wholly taxable receipts to the extent of the percentage of radio families within the City to the total number of radio families covered by the station. All other gross receipts from the sale of sponsored time with respect to stations having New York City call letters are allocable receipts, and are required to be allocated on the basis of the following factors:

(1) The property factor. This factor has been discussed above.

(2) The wages and salary factor. This factor has also been discussed above.

(3) The radio family factor, which is a percentage determined by taking the number of radio families within the City of New York and dividing it by the total number of radio families covered by the station. Incidentally, this percentage will be the same as the proportion of wholly taxable receipts to total receipts. In the computation of the average percentage, an adjustment will have to be made where the percentage determined is above 66⅔% or below 33⅓%, as indicated previously. (Article 214, Comptroller's Regulations)

Allocation of Receipts from Royalties

Persons subject to the General Business and Financial Tax Law who maintain no office or other place of business outside the City of New York are required to include in the measure of the tax the total amount received as royalties for the use of or for the privilege of using patents, copyrights, secret processes and formulas, good will,

trade marks, trade brands, franchises, and the like.

Where a person having receipts from royalties maintains a place of business both within and without the City of New York, an allocation is permitted of that proportion of the total amount received as royalties which the cost of doing business within the City of New York bears to the total cost of doing business throughout the world, subject to the following limitations:

(1) If the principal office of such person is within the City of New York, and the cost of doing business within the City exceeds 66⅔% of the total cost of doing business, then a maximum percentage of 66⅔% shall be used to apportion such receipts to the City.

(2) Where the principal office is within the City of New York, and the cost of doing business within the City is less than 33⅓% of the total cost of doing business, then a minimum percentage of 33⅓% shall be used to apportion such receipts to the City.

(3) If the principal office is outside the City of New York, the actual percentage represented by the ratio which the cost of doing business within the City of New York bears to the total cost of doing business shall be used to apportion such receipts to the City, unless such percentage exceeds 66⅔%, in which event it shall be reduced to 66⅔%.

The "cost of doing business" within the City of New York shall be deemed to include all compensation paid to officers and employees who work in or from or are attached to New York City places of business, and all other expenses paid or incurred in the operation of such places of business or in connection with business conducted within the City of New York, except materials, labor and manufacturing expenses entering directly into the cost to fabricate or produce a manufactured article or articles. The same rule shall apply when computing the total cost of doing business. (Article 250, Comptroller's Regulations)

Formula for Allocation of Dividends and Interest

Holding companies, within the meaning of the General Business and Financial Tax Law, are required to report dividends and/or interest received from controlled corporations, and pay a tax at the financial rate of 2/5ths of 1%.

It is immaterial whether a holding company is a domestic or a foreign corporation, as long as it maintains an office within the City of New York from which is conducted, in whole or in part, the business of the organization. Taxpayers regularly engaged in general business, as well as being a holding company, are required to segregate all dividends and/or interest received from controlled corporations, and report same as gross income from financial business. These taxpayers are required to use the "B" form in reporting gross receipts from regular operations, and the "F" form for reporting gross income from controlled corporations.

The following rules apply:

(1) Where the controlled corporation or corporations are located wholly within the State of New York, the holding company is required to include in the measure of the tax the total amount of dividends and/or interest received during the basic period from such controlled corporations.

(2) Where the controlled corporation or corporations are located partly within and partly without the State of New York, or wholly without the State, the holding company is permitted to make an allocation of such dividends and/or interest received.

The allocation of dividends and interest is based upon: (1) the property factor, (2) the wages and salary factor, and (3) the receipts factor. In computing the percentages, the figures employed will reflect the totals of the holding company and the controlled corporations. Aside from that, the calculation of the average percentage follows the regular allocation formula prescribed by the Comptroller, except that, in arriving at the receipts factor per-

centage, the receipts *attributable to places of business situated within the City of New York* will be the numerator, and the total receipts from sales made or services rendered by the group throughout the world will be the denominator.

Where the resultant average of the percentages exceeds 75%, it shall be reduced to 75% for the purpose of allocation. Where the resultant average of the percentages is less than 12½%, it shall be increased to 12½%. The apportioned amount of dividends and/or interest to be included in the measure of the tax of the holding company is determined by applying the resultant average of the percentages (with a maximum of 75%, or a minimum of 12½%) to the total amount of dividends and/or interest received by the holding company from controlled corporations located partly within and partly without the State of New York, or wholly without the State. As previously mentioned, dividends and/or interest received from controlled corporations located wholly within the State of New York are to be fully included in the measure of the tax.

Investment trusts conducting business both within and without the City of New York are also permitted to allocate receipts from dividends and/or interest on the basis of the cost of operating the office within the City of New York to the total cost of doing business within and without the City, subject to a maximum allocation of 75% and a minimum allocation of 25%. (Article 305, Comptroller's Regulations)

Recent Decisions and Administrative Rulings

(Continued from page 475)

should be noted that a vendor may not accept a certificate from a New York City customer who arranges for transportation of the property to a New York City destination; in that event he must collect the use tax from the customer. The provisions of this ruling are given effect in all transactions taking place since the inception of the use tax, July 1, 1940, and provide a feasible solution to a difficult problem often confronting the taxpayer.

In concluding this paper on important recent developments in the law, I want to note that the decisions reviewed this evening represent holdings of the highest court of the state, or of intermediate appellate courts from which no further appeal was taken. As I suggested in my opening remarks, the endless search for clarification of the law makes it natural that other cases, some decided by lower courts, are even at this moment in the course of litigation. It would be fruitless to discuss those matters with you, no matter how interesting the problems they present, for until a higher body has spoken, no lower court may rest lightly. The ultimate resolution of those cases must therefore await another day.

Determination of Classification as Financial or Commercial Business for Gross Receipts Tax Purposes

By Max Brofman

The importance of the New York City General Business and Financial Tax Law, if not recognized before, was certainly brought to the forefront on July 1, 1948, when the rates of tax imposed by that law were doubled over the previous year. Up to that time, many taxpayers were prone to accept the law, the regulations promulgated thereunder, and the rulings of the Bureau of Excise Taxes administering the law, without much desire to contest certain provisions of the law because of the fact that usually, and by and large, the amount of the tax was comparatively small. However, with the doubling of the tax rates there seems to be a growing tendency to question seriously the application of the law to different tax situations, for the impact of the tax is now more poignantly felt.

With the added impact brought about by the doubling of the rates has come about a realization of the importance between the distinction that is made in the law and the regulations between those businesses that are classified as a financial business and those classified as a general business. This is so because of the fact that there is a difference in the rate of tax and in the base upon which the tax is computed between each class of business. As you know, the rate of tax since July 1, 1948, in the case of a financial business is 2/5 of 1% of gross income, whereas immediately prior thereto it was 1/5 of 1%. In the case of a general business, the rate of tax since July 1, 1948, is 1/5 of 1% of gross receipts whereas immediately prior thereto it was 1/10 of 1%. In addition, the base upon which the tax is computed varies with each classification. In the case of a financial business the tax is imposed upon *gross income*. Gross income is defined as the total amount of receipts of a person engaged in a financial business, excluding the cost of property sold or moneys or credits received in repayment of advances, credits and loans, but not to exceed the principal amount thereof and excluding deposits. In the case of a general business the tax is imposed upon *gross receipts* which is defined as the receipts received in or by reason of any sale made or services rendered, or commercial or business transaction had in the city, without any deduction therefrom on account of the cost of property sold, cost of materials used, labor or services or other costs, interest or discount paid, or any other expenses whatsoever, except certain receipts from sales or services which are specifically exempt in the law. Therefore, it should be considered a matter of great importance to a taxpayer whether or not his business, in whole or in part, is classified as a financial business or a general business.

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This paper was presented by Mr. Brofman at a technical meeting of the Society held at the Engineering Societies' Building on May 17, 1949, under the auspices of the Committee on Municipal and Local Taxation.

The determination as to whether a business is financial or commercial is not an arbitrary act on the part of the Comptroller. The provision for classification of businesses into financial and commercial is made in the various laws authorizing the imposition of the tax. The State Enabling Act makes this classification, as well as the New York City Local Law itself. In addition to the laws which set up these classifications, specific powers are granted to the Comptroller of the City of New York to classify businesses into one category or the other. Pursuant to such powers, the Comptroller has issued certain regulations, and from time to time rulings are made interpreting the regulations and the law in connection with this subject. Let us examine some of the provisions of the law creating the classifications of businesses into financial and commercial.

We start with the New York State Enabling Act which is found in Article 2B of the General City Law, which not only authorizes the city to impose the tax but sets forth what is commonly referred to as a "model law" to be enacted by the city pursuant to such authority. The State Enabling Act at the outset in the model law defines a financial business.*

It also defines gross income of a person engaged in a financial business as well as the gross receipts of a person in general business. The model law also grants certain powers to the chief fiscal officer of the city amongst which is the following:

> "To determine whether any trade, business, profession, vocation, or commercial activity shall be in whole or in part classified as financial business or otherwise; and in case any trade, business, profession, vocation or commercial activity shall be classified in part as financial business, to set forth the manner of computing the tax hereunder upon each part in accordance with such classification."

The model law has even gone further by expressly providing that the business of insurance shall not be deemed to be a financial business.

The model law which appears in the Enabling Act has been adopted and enacted by the City of New York in substantially the same form. It is thus apparent that whatever classifications or distinctions are made between financial or general businesses in the city's law have been originally prescribed by the State Legislature. In addition, by virtue of the power vested in the chief fiscal officer of the city by the State Enabling Act and the City's local law, the Comptroller of the City of New York has classified certain businesses as financial businesses. He has exercised this power sparingly because the predominant nature of most businesses is commercial. He has exercised this power by the promulgation of regulations, as well as by the issuance of rulings from time to time.

It is of interest to note the additional classifications made by the Comptroller. In Article 301 of the regulations promulgated by the Comptroller reference is made to the definition of a financial business as it appears in the local law. The Comptroller has elaborated thereon and has classified the following businesses as being engaged in a financial business:

(a) Members of the New York Stock Exchange, the New York Curb Exchange, or similarly constituted exchanges, who act primarily as
  (1) commission brokers,
  (2) floor brokers,
  (3) floor traders,
  (4) odd-lot dealers,

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* *"Financial business."*

The services and transactions of private banks, private bankers, dealers and brokers in money, credits, commercial paper, bonds, notes, securities and stocks, monetary metals, factors, and commission merchants, and where the chief fiscal officer shall so determine as a fact, dealers in merchandise where the spread or difference between the cost of goods sold and the sale price is analogous to or in the nature of a commission and does not in any event exceed three per centum of the cost of goods sold, and such determination of fact by the chief fiscal officer shall be final.

(5) odd-lot brokers,
(6) bond brokers and dealers, or
(7) specialists;

(b) Finance companies;

(c) Traders in securities, i.e., persons who buy and sell or hold stocks, bonds and/or other securities and are engaged in such activities to such an extent as to constitute carrying on a trade, business, vocation or established commercial activity;

(d) Corporations organized as investment trusts, and companies or associations created under trust instruments or otherwise whose business is analogous to that of an investment trust;

(e) Personal loan companies and other licensed lenders;

(f) Dealers and brokers in royalty interests in oil, gas and mineral deposits;

(g) Persons acting as speculators in commodity futures;

(h) Commodity brokers;

(i) Pawnbrokers with respect to the lending of money on pledges;

(j) Dealers in monetary metals, i.e., persons engaged in the business of buying and selling gold and silver in bullion or fine state as distinguished from buying and selling gold and silver which have been processed or manufactured into products or articles having specific and customary industrial, professional or artistic uses.

You will observe that the model law as well as the New York City local law authorizes the chief fiscal officer of the City (in our case the Comptroller of the City of New York) to determine whether any trade or business shall be *wholly or in part* classified as a financial business or otherwise. This is direct authority for splitting a single business into separate classifications for gross receipts tax purposes. In actual practice this is commonly done. As a matter of fact, in Article 305 of the regulations, relating to the taxation of interest and dividends received by persons engaged in a financial business, the Comptroller has provided that if a taxpayer is regularly engaged in general business and in addition thereto is a holding company (which is classified as a financial business), it is required to file a return on a combination basis; that is to say, it is required to report its gross receipts from its general business on what is commonly known as the "B" form paying the tax at the general business rate, and report its gross income from controlled companies on what is commonly known as the "F" form and pay the tax thereon at the financial rate. For example: a manufacturing corporation, which is also a holding company, has sales of a million dollars. In addition thereto, it receives interest and dividends of one hundred thousand dollars from companies controlled by it. As to the million dollars, it is classified as a general business and required to pay a tax of 1/5 of 1% thereof. As to the one hundred thousand dollars, it is classified as a financial business and is required to pay a tax of 2/5 of 1% thereof. As a matter of fact, the Bureau has gone further and even split up the income of strictly holding companies into income from controlled companies and income from non-controlled companies. The Bureau has classified the income from controlled companies as being derived from a financial business, and the income from non-controlled companies as being derived from a general or commercial business. Obviously, as to non-controlled companies, it is not a holding company, any more than is a manufacturing corporation owning shares of stock in another corporation, representing less than a controlling interest therein.

Another instance of splitting a single business into separate classifications may be found in dealers in merchandise. As you know, dealers in merchandise are subject to tax as a financial business where the Comptroller shall determine as a fact that the spread or difference between the cost of goods sold and the sales price is analogous to or in the nature of a commission and that such spread does not in any event exceed 3% of the cost of goods sold. It often happens that such dealer in merchandise has sales where the spread or difference between the cost of goods sold and the sales price (gross profit) is in excess of 3% of the cost of goods sold, as well as sales where

the gross profit is 3% or less. In such cases, he is required to file two returns, one showing the sales where the gross profit is in excess of 3%, (Form B), in which event he is required to report the gross receipts from such sales and pay the tax thereon at the general business rate, and another (Form F) showing the sales where the gross profit is 3% or less, in which event he is required to report the gross profit from such sales and pay the tax thereon at the financial rate. In connection with an audit by the Bureau of such dealer in merchandise, an examination is made of the taxpayer's sales upon which the gross profit only was reported. A test check is used for this purpose.

Another business which has been divided into a financial and general business by the Comptroller is that of pawnbrokers. In Article 308 of the regulations, pawnbrokers are classified as a financial business with respect to interest derived from lending money on pledges. Where the pawbroker sells tangible personal property over the counter, he is regarded as being in a general business and is required to report the gross receipts from such sales on the so-called "B" form.

Factors and commission merchants are classified as being in a financial business and are required to pay the tax on their gross income (Article 306 of the regulations). The Comptroller has made a distinction between a factor and a commission merchant on the one hand, and selling agents or merchandise brokers, who generally sell property only in the name of the principal and usually have no possession, management or control of the goods or any special property or lien therein. Such selling agents or merchandise brokers are classified as being engaged in a general business except where the selling agent is also a "del credere agent," that is, in consideration of additional compensation agrees to guarantee to his principal the solvency of the debtor and the punctual discharge of the debt, in which event such agent is classed as a factor and is deemed to be engaged in a financial business.

I made reference to dealers in merchandise. As you know, in order for a person engaged in business to qualify as a dealer in merchandise, it must be established, to the satisfaction of the Comptroller, that the spread or difference between the cost of goods sold is analogous to or in the nature of a commission, and that the spread does not in any event exceed 3% of the cost of goods sold. In determining the gross profit of a qualified dealer in merchandise the Comptroller has provided (Article 307 of the regulations) that the cost of goods sold, including any incidental expenses paid or incurred in connection with the *acquisition* thereof, but not including salaries, wages and overhead, may be deducted from the gross receipts from sales. However, in spite of these requirements the Comptroller has restricted the classification of dealers in merchandise, and hence, as a financial business, only to wholesale dealers in certain types of merchandise, namely, *dealers in perishable goods,* such as, butter and eggs, fruits and vegetables, unprocessed meats and dressed poultry, unprocessed fish, and also to wholesale dealers in sugar, and wholesale tobacco jobbers where the sales of cigarettes and tobacco (excluding cigars) equal at least 75% of the total sales of the year.

Presumably the reason for restricting the classification of wholesale dealers in merchandise as a financial business to those dealing in perishable goods, and to sugar and tobacco jobbers, is the fact that from experience it has been demonstrated that these goods must be disposed of within a comparatively short period of time, and/or because the margin of profit is so minute as to make it unfair and inequitable to impose a tax on the *total* receipts from sales.

In passing, it might be interesting to note that persons who are engaged in manufacturing, fabricating or process-

ing the merchandise dealt in cannot qualify as dealers in merchandise, even though they would otherwise be deemed dealers in merchandise by virtue of the fact that the spread or difference between the cost and sales price of the goods is analogous to or in the nature of a commission, and that such spread does not in any event exceed 3% of the cost of goods sold.

Up to this point I made no reference to any cases brought before the courts on the question involving the proper classification of a business either financial or commercial. The reason for that is that there has been a dearth of litigation. In fact the only case that comes to my mind involving the question at all is the case of *Realty Associates Securities Corp.* v. *Portfolio*, 274 App. Div. 924 (Mem.). In that case a deficiency assessment was made against the taxpayer as a financial business. The taxpayer was a domestic corporation organized for the purpose of financing installment contracts of sale of real property owned and sold by its affiliates. Its business was restricted to the purchase of first and second mortgages, participations in mortgages, building loans, installment sale contracts and the investment of funds in legal securities. In addition, it held and operated real estate only to protect its mortgage lien interests. For part of the period involved the taxpayer reported its receipts as a financial business but for the latter years it filed returns as a general business. The taxpayer's contention was that since the predominant nature of its business for the latter years was real estate, it should be taxed as a general business, and not as a financial business as to any part. The city contended that the laws and regulations do not require that a person's entire business be classified as either financial or general on the basis of the predominant nature of its business; that they authorize classification of parts of a business, and the taxing of each part, either as a financial business or as a general business. When the case came up before the court (Supreme Court, Appellate Division) a very important procedural question was also involved. The court merely confirmed the Comptroller's determination without opinion, (there being one dissent in part by one judge relating to the tax on certain income). I believe the case can be taken as authority for the proposition that under the law and the regulations a business need not be classified either all financial or all general, but that it may be classified in part financial and in part general, and the tax computed upon each part in accordance with each classification; that the classification of a business is not required to be made on the basis of the predominant nature of the business.

In concluding, one thing should be made clear. Wherever any question arises as to whether a business falls in one classification or the other (that is, financial or general) the determination by the Comptroller is generally final, if there is ample "warrant in the record" and a "reasonable basis in law." (*Matter of Mounting and Finishing Co. v. McGoldrick*, 294 N.Y. 104). The development of any evidence, therefore, in support of either classification should be based upon a full presentation of all the facts that would tend to bring the case within one or the other of such classifications.

Procedure in Auditing Returns and Processing Disputed Matters

By Louis Goodgold, C.P.A.

Before proceeding with the subject matter assigned to me, it must be pointed out that all of the local excise tax laws are administered jointly by the offices of the Comptroller and Treasurer. However, the power to make audits is conferred exclusively on the Comptroller. Returns are filed with and the taxes due thereon are paid to the City Treasurer. After such returns are checked by the Treasurer's Office, they are forwarded to the Bureau of Excise Taxes, a division of the Comptroller's Office, located at 74 Trinity Place, where they are permanently retained.

This Bureau, which is administered by a Special Deputy Comptroller assisted by an executive staff, is divided for administrative purposes into a number of units. Those pertinent to the auditing and processing of disputed matters are the Audit Control Unit, the Audit Units, the Reviews Unit, the Hearings Unit and the Tax Counsel Unit.

All returns forwarded to the Bureau of Excise Taxes are directed to the Audit Control Unit where they are processed, and those selected for audit are assigned to the respective audit units. The Audit Control Unit maintains a record of all registered vendors arranged by types of business. Immediately upon the assignment of a taxpayer's returns for audit, the date of such assignment is entered in the register opposite the name of the taxpayer; and upon completion of the audit a second entry is made showing the period covered by the audit. Periodically, this register or code book as it is sometimes called, is examined to determine those taxpayers whose returns have never been audited or whose returns have not been audited over an extended period of time. Where warranted, the returns of such taxpayers are also selected and assigned for audit. This unit also maintains a register which in effect is a history record of every case from the time the returns are assigned for audit until a final determination is mailed to the taxpayer.

There are nine audit units within the Bureau and these include the following:

- Sales Tax Field
- Sales Tax Office
- Business Tax
- Compensating Use Tax
- Utility and Conduit Taxes
- Hotel and Pari-Mutuel Taxes
- Bankruptcy and Assignment
- Bulk Sales
- Investigations

Assignment of Returns for Audit

The units to which returns are assigned for audit are determined by the

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This paper was presented by Mr. Goodgold at a technical meeting of the Society held at the Engineering Societies' Building on May 17, 1949, under the auspices of the Committee on Municipal and Local Taxation.

types and nature of the businesses in which taxpayers are primarily engaged.

Thus, the returns of persons primarily engaged in the sale of tangible personal property at retail are assigned to the Sales Tax Field or Office Audit Units depending upon whether the annual sales of such persons are over or under $100,000 per annum. If the annual sales are over $100,000, the returns are assigned to the Sales Tax Field Unit. If the annual sales are $100,000 or less, the returns are assigned to the Sales Tax Office Audit Unit.

The returns of manufacturers, wholesalers and jobbers who do not make sales at retail or who make incidental sales at retail, and persons engaged in a financial business are assigned to the Business Tax Unit.

The returns of persons engaged in business primarily as building or plumbing contractors, advertising agencies, or other types of service industries and who purchase tangible personal property for their own use and not for resale, are assigned to the Compensating Use Tax Unit.

The returns of persons engaged primarily in the hotel business are assigned to the Hotel Unit. The returns of pari-mutuel organizations are also assigned to this unit.

The returns of utility corporations and persons engaged in the sale of utility services as defined by law are assigned to the Utility Tax Unit. The returns of conduit companies are also assigned to this unit.

Simultaneously with an audit of a taxpayer's returns under any local law, the unit making such audit is also required to audit the returns of the same taxpayer under all other laws pursuant to which such taxpayer is liable for tax. To illustrate: The Hotel Unit makes audits of persons primarily engaged in the hotel business and liable for the hotel tax. Persons so engaged also have receipts from the sale of food, liquor and other articles of tangible personal property, and receipts from telephone and other services, and therefore are also subject to tax under the sales, business and utility tax laws. Accordingly, the Hotel Unit is required to audit the returns of such person under all of the aforesaid laws.

The Bankruptcy & Assignment Unit audits returns filed under all laws by persons who have filed petitions in bankruptcy or who have made general assignments for the benefit of creditors.

The Bulk Sales Unit audits returns filed under all laws by persons who have filed or who are required to file notices of bulk sales.

The Investigations Unit, as its name indicates, conducts special investigations of taxpayers, and audits all returns assigned to it by the Deputy or his Assistant, and oftentimes re-audits cases where the original audits have been rejected.

Audit and Review of Returns

Preliminary to the commencement of an audit by the Sales or Compensating Use Tax Units, the taxpayer is notified by letter of a pending audit. Form A-20 is used for said purpose. The date of the commencement of the audit, the period selected for a test check, and the schedules and records required to be submitted at the time of audit in support of the taxpayer's gross receipts and deductions are set forth in the letter. The taxpayer is afforded an opportunity to designate another date if the date fixed in the letter is not convenient to him provided, however, such other date is not more than thirty days from the date of the letter. If no other date is requested, the audit commences on the date fixed in the letter. For various reasons, this practice of notifying the taxpayer by letter of a pending audit is not followed by the other audit units.

With the exception of the Bulk Sales and Bankruptcy & Assignment Units, all audits are conducted in the field. Audits by the Bulk Sales Unit are made in the office of the Bureau. Audits by the Bankruptcy & Assignment Unit are made in the field or in the office of the Bureau, as the case may be.

The returns assigned to an audit unit are distributed to the respective group chiefs in that unit. The latter in turn assign such returns to the auditors under their supervision.

Every audit covers a period of not less than three years provided, however, the taxpayer has been engaged in business in the City for three years. Where the taxpayer has been engaged in business in the City for a shorter period, the audit covers such shorter period. Where a taxpayer files returns which are wilfully false or with fraudulent intent to evade the tax, or where he files no returns as provided by law, the audit is extended beyond the three year period without limitation.

In connection with every audit, the auditor is required to give consideration to all factors having a bearing on the procedure to be followed. Included in such factors but not limited thereto are the following:

- Technical problems involved.
- Results of prior audits, if any.
- Nature of the taxpayer's business.
- Adequacy of the gross receipts reported.
- Percentage of deductions taken.
- Changes in the method of doing business, if any.
- Bureau's instructions to auditors, and special rulings relative to businesses of a similar nature.

Upon completion of the audit, the returns are either accepted as filed or a recommendation for a proposed deficiency assessment is made by the auditor. The auditor's report is subject to review by his superiors and the Reviews Unit created for said purpose. A proposed tax deficiency is not official until approved by the Special Deputy Comptroller. At any stage prior to such approval, the auditor's recommendations may be rejected. The rejection may be based on an improper application of the law or regulations, on an insufficiency of the period selected for a test check, or on any other ground which has a bearing on a proper determination of a taxpayer's liability for tax.

Rights and Privileges of the Taxpayer

A taxpayer, or his duly authorized representative, may appear at the office of the Bureau at any stage prior to the issuance of a determination. He may appear before the auditor's group chief or his superiors immediately upon the completion of an audit for the purposes of discussing the application of the law and the regulations to the taxpayer's business, or to obtain copies of the auditor's work sheets, or to work out a settlement for the purposes of signing a consent and waiver assessment. If the taxpayer signs a consent and waiver assessment, the same is subject to review as described heretofore and is not official until approved by the Special Deputy Comptroller. After an assessment has been reviewed and approved, a determination is mailed to the taxpayer or his duly authorized representative, as the case may be. If the determination is based on a consent and waiver, Form A-17 is issued. This is a notice to the taxpayer that the Comptroller has confirmed the consent and waiver signed by the taxpayer covering his tax deficiency for the period indicated therein. The amount of the deficiency and the periods covered by the audit are set forth, and the taxpayer is required to pay the tax due within the time specified. Where the taxpayer does not sign a consent and waiver to the proposed determination, Form A-21c is issued. This is a thirty-day letter sent by registered mail notifying the taxpayer of a determination of a tax deficiency. The amount of the deficiency and the periods covered by the audit are set forth therein. The taxpayer has thirty days' time from the date of the mailing of the letter within which to pay the amount determined, or in the event of his failure to agree to the determination to make written application to the Comptroller for a hearing thereon. If no such application for a hearing is made, the original determination becomes final and irrevocable. If such application is made, a date for a hearing thereon is fixed by

the Hearings Unit and the taxpayer is duly notified thereof.

Informal and Formal Hearings

On the date fixed for the hearing, the taxpayer or his duly authorized representative may appear before the Hearings Unit for an informal conference to discuss the propriety of the assessment or for the purpose of arriving at a basis for a settlement. If a settlement is reached, the taxpayer is requested to sign a consent and waiver to the amount agreed upon, after which he is formally notified thereof by letter. A copy of this final notification is sent to the City Treasurer's Office for collection.

In the event that no agreement is reached at the informal conference, a date is fixed for a formal hearing at which time the taxpayer may appear in person or be represented by his duly authorized representative who must be an attorney-at-law. At such formal conference, the Bureau is represented by a formal conferee who is the presiding officer and a representative of the Office of the Corporation Counsel. There is also present a reporting stenographer designated by the Bureau. The witnesses are sworn and written testimony is taken. Generally speaking, these formal hearings are in the nature of a quasi-judicial proceeding and are conducted in accordance with the rules of evidence as practiced before the courts of the State of New York. Copies of the official minutes may be had upon request and payment therefor at a cost of 25¢ per page.

At the conclusion of the hearing, the conferee prepares his report which is subject to review and approval in the same manner as outlined in the case of original determinations except that such report is also subject to approval by Tax Counsel. Based upon such approvals, the Comptroller gives notice of his final determination to the taxpayer by mail. The final determination of the Comptroller is reviewable for error, illegality or unconstitutionality or for any reason whatsoever by a proceeding under Article 78 of the Civil Practice Act if application therefor is made to the Supreme Court within thirty days after the giving of the notice of such determination. Such a proceeding cannot be instituted unless the amount of any tax sought to be so reviewed, with penalties and interest thereon, if any, is first deposited with the Treasurer, and an undertaking filed to cover costs.

Audit Procedures

Every audit includes a verification of gross receipts, fixed assets and expense purchases, deductions and tax collections.

Where a taxpayer maintains adequate records and the receipts reported by him are in accord with such records, the receipts reported will be accepted as correct. If they are not in accord with such records but are understated, the amount understated will be assessed providing the taxpayer is unable to sustain the burden of showing that such understatement represents non-taxable sales.

The City is not bound to accept the taxpayer's statements (unsupported by any records) which are contrary to entries on his books pointing to a greater amount of sales than the taxpayer reported.

Where a taxpayer does not maintain records or maintains records which are inadequate, and there is a clear indication that the receipts reported are understated, the Bureau for the purpose of estimating the tax will resort to the use of external indices, such as number of employees of the taxpayer, rentals paid, stock on hand and/or other factors.

In situations where fraud is indicated, the taxpayer's returns are referred to the Investigations Unit for a more detailed audit. In that connection, the records of related vendees, banks, insurance companies, personal finance companies, the Motor Vehicle Bureau and other agencies will be examined for the purpose of estimating the tax. Where fraud is established,

the audit is generally extended beyond the statutory period.

Non-recurring purchases such as fixed asset purchases are verified by an examination of all fixed asset accounts. All entries, both debit and credit, are carefully checked with supporting data, and wherever it appears that no sales or compensating use tax has been paid on such purchases, a tax deficiency is assessed thereon. Out-of-town purchases are assessed in full without allowance for trade-ins.

With respect to expense purchases, a period, generally three months, within the audit period is selected for a test check. All expense purchases made during such period are examined. Those purchases upon which no sales or compensating use tax has been paid are listed, and the total amount thereof ascertained. A percentage of unreported taxable purchases for the test period is then determined and applied to the total purchases for the audit period to ascertain the total unreported taxable purchases. Where warranted, other formulae are used to determine unreported taxable purchases for the period covered by the audit.

With respect to the verification of deductions, the auditor will check in detail the items listed on the schedules submitted by the taxpayer for the test period. A percentage of error for each class of deductions, if any, is ascertained and applied to the same class of deductions for the audit period. The resulting amounts are included in the proposed deficiency assessment.

A second test period may be used in certain cases, if the facts warrant such action. Where such second test period is used, average percentages of error for both test periods are determined and applied in the same manner as in the case of a single test period. Where there has been a change in the nature of the taxpayer's business during the period covered by the audit, the test periods used will be those within the audit period before and after such change, and the resulting percentages of error will be applied to the deductions of the respective periods affected thereby.

If the required schedules and proof are not submitted, the deductions taken will be disallowed. All receipts are presumed to be taxable and the burden of proving that such receipts are not taxable is on the taxpayer.

With respect to sales claimed to have been delivered by the vendor to points outside the City, the Bureau will accept as proof of delivery parcel post receipts, railway express receipts, or other documentary evidence of delivery. Where the taxpayer claims that such out-of-City deliveries were made by his own trucks or messenger, as the case may be, the Bureau will resort to a verification of such deliveries by direct communication with a representative number of vendees. Unsubstantiated out-of-City sales will be disallowed.

Because of the experience of the Bureau with respect to deductions for out-of-City sales claimed by automobile dealers, and as a result of numerous conferences with automobile dealers and their representatives pertaining to this subject, a special procedure effective April 1, 1948, was instituted for the verification of such sales. Under this procedure, three methods are set forth. The dealer may use either one of them or a combination of all of them. Under the first method, the dealer may engage regularly licensed common carriers to make such out-of-town deliveries. The common carrier is required to attach its own plates to the car at the time it is picked up at the dealer's place of business and obtain a signed freight receipt from the vendee showing the car was actually delivered to the vendee outside the City of New York. This receipt is required to be returned to the dealer and retained by him as proof of such out-of-City delivery. Where there is a compliance with these requirements, the out-of-City sales are allowed as a deduction. Under the second method,

the dealer is required to collect a tax on all sales of automobiles to out-of-City customers regardless of the place of delivery. The customer at the time the car is purchased files with the dealer a form furnished by the latter which is a combination protest and claim for refund. The dealer files monthly schedules with the Bureau on which are listed all sales to out-of-City customers from whom the tax was collected. Attached to said monthly schedules are the combination protest and claim for refund forms executed by the vendees. The dealer retains the taxes collected by him in escrow in a special account pending a verification of the claims by the Bureau with the respective vendees, after which the Bureau advises the dealer to return the tax thus collected to his vendees, or to pay over the same to the City Treasurer. In any event, all taxes held in escrow for more than six months and not returned to the vendees must be paid over to the City.

Under Method #3, the dealer does not collect the tax on sales delivered out of the City but nevertheless is required to file monthly schedules with the Bureau, listing thereon all alleged out-of-City sales. The Bureau verifies such out-of-City sales by direct correspondence with the vendees and by examination of the taxpayer's records. All out-of-City sales not substantiated are disallowed and the dealer is required to pay over to the City the tax due thereon.

The difference between Methods #2 and #3 is that under Method #2 the dealer does not sustain a personal loss if the alleged out-of-City sales are disallowed, since he has collected the tax thereon in advance, whereas under Method #3, the dealer must pay the tax out of his own funds.

Sales for resale are allowed if supported by resale certificates obtained from vendees. A vendee is not entitled to furnish a resale certificate unless the merchandise purchased by him is for resale in the form of tangible personal property. If the purchase is made for any other purpose, the vendee is not entitled to submit a resale certificate. In such case he is required to pay the tax to his vendor. To illustrate: A vendee engaged in the sale of men's suits at retail purchases such suits from a manufacturer thereof. The vendee is entitled to submit a resale certificate to the manufacturer. However, if such vendee purchases cigars from a cigar dealer to give away to his customers, he is not entitled to furnish a resale certificate to the cigar dealer, and the latter is required to collect a tax on the selling price of the cigars.

Time does not permit of a detailed discussion of the audit procedure with respect to verification of all classes of deductions. Suffice it to say that documentary proof in all cases is required in support thereof. A mere statement on the part of the vendor without documentary proof is insufficient to entitle him to exemption on claimed non-taxable receipts.

Tax Collection Problems

Under the Hotel and Sales Tax laws, the question of tax collections is an important factor. Under these laws, the tax is imposed upon the receipts from every taxable transaction as distinguished from a tax imposed upon total taxable receipts, as is the case under the Business Tax, Utility Tax and Conduit Tax laws. Under the Hotel Tax law, the application of the base rate of 5% on the rent of every taxable occupancy may result in a tax which is in excess of 5% of the total rent. Thus, a tax on every rental of $2.25 per day will be 12¢ or 5.33%; a tax on every rental of $2.50 per day will be 13¢ or 5.2%; a tax on every rental of $2.75 per day will be 14¢ or 5.09%, etc. Where such transactions are numerous, the additional tax for a three-year period resulting from this windfall will be considerable. In such case, the hotel operator must pay over to the City Treasurer the tax collected or 5% of the total taxable rentals, whichever is greater.

Under the Sales Tax law, the Comptroller has promulgated a schedule of amounts upon which the tax is required to be collected, with the result that the tax on every taxable transaction other than sales of 50¢ or multiples thereof is either more or less than 2%. This schedule is as follows:

On sales of 1¢ to 16¢......	no tax
From 17¢ to 66¢..........	1¢ tax
From 67¢ to $1.16.........	2¢ tax
On every even dollar in excess of the above amounts	2¢ additional

Under this schedule, a retailer will collect exactly 2% on sales of 50¢. On 32 amounts, that is to say, on sales from 1¢ to 16¢ and from 51¢ to 66¢ he will collect less than 2%; and on 66 amounts, that is to say, on sales from 17¢ to 49¢ and from 67¢ to 99¢ he will collect more than 2%. In other words, when applied to business generally, a retailer will collect a tax in excess of 2% on more than twice the number of amounts than he will collect a tax of less than 2%. Accordingly, some retailers will collect a tax which will be more and others less than the tax collected at the base rate when applied to the gross receipts from all their taxable sales.

It is also recognized that some retailers, because of their method of doing business and the amount of their individual sales transactions, will collect no tax whatsoever; for example retailers of 5¢ packages of gum sold exclusively through vending machines. The schedule being part of the law, the retailer collecting a tax in accordance therewith, must pay over to the Treasurer the tax collected, or 2% of his taxable sales, whichever is greater.

Where a retailer has computed the tax on every taxable transaction and maintains adequate records showing the total taxes thus collected, he must pay over the same to the City Treasurer if it is in excess of 2% of his total taxable sales including taxable sales of 16¢ and less; otherwise, he must pay over 2% of such sales.

Where the retailer does not maintain records of tax collections, or maintains records which are inadequate, the City's auditor will select a test period and determine the effective rate of tax collectible on all taxable sales made during said period. The rate thus determined, or 2%, whichever is greater, will be applied to the retailer's total taxable sales for the audit period to ascertain the amount due the City.

This in substance is a statement covering the audit procedure and the processing of disputed matters in the Bureau of Excise Taxes of the Office of the Comptroller.

AN ADIRONDACK VIEW

SYSTEMS. We have just ordered, paid for, and received a copy of a new book on accounting systems and their installation. It looks like a good book. But we fail to find two very important items in the program for small businesses, namely—

1. The books used in the system must be small enough to fit the safest available place of overnight storage.
2. The accounting methods used must fit the accounting possibilities of the person who is going to do the bookkeeping.

A few years ago a wholesaler's place went up in smoke; the only thing left was the safe, which was under a pile of dough that was baked by the fire, after the flour, which was stored overhead, dropped into the office and was mixed with water by the firemen. (We never did find out where the yeast came from.) The new visible general ledger which we had just previously made for them was safe in the safe; all their other accounting books were too large to go in!

You can figure out #2 yourself; or take a day off some time and try to make a bookkeeper out of the snappy blond stenog—or the corporation's president-treasurer.

And we will be seeing you at Saranac Inn in September; better over-work as much as possible until then, so you will get more enjoyment from the days there. But don't overdo the over-work and land in a hospital.

LEONARD HOUGHTON, C.P.A.
Of the Adirondack "Chapter."

Accounting for Cooperative Apartment Buildings

By ALFRED L. CAMPBELL, C.P.A.

A COOPERATIVE apartment building, as you probably know, is a building in which the occupants are the owners, by reason of stockholdings in the owning corporation. At the organization of the corporation each rentable unit is assigned a number of shares reflecting the relative value of the space, and the tenant-owners, by purchasing these shares, thereby obtain the right to occupy the apartment, usually under a long-term proprietary lease. The principal income is derived from assessments made against each tenant-stockholder. The proprietary rent is fixed by the Board of Directors of the owning corporation which is, in turn, elected by the tenant-stockholders.

One of the primary purposes of the accounting records for a cooperative apartment building is to enable the management easily to prepare a statement of the cash transactions at the end of each month. However, they must also be kept in such form as to disclose all the necessary detailed information needed for all other accounting purposes.

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This paper was presented by Mr. Campbell at a technical meeting of the Society held on May 2, 1949, at the Engineering Societies' Building, under the auspices of the Committee on Real Estate Accounting.

Another purpose stems from the necessity for compiling data regarding income and expenses at monthly or other stated periods during the year, for comparison with the annual budget. Of course, there is also the need to prepare the usual periodic financial statements.

Budget

A careful budget is prepared, disclosing an estimate of the amount of funds required for all disbursements during the ensuing year, including all expenses in connection with operations and maintenance, taxes, mortgage interest, etc., and also including mortgage amortization, if any. If there are any stores or servants' rooms (or any other space owned by the corporation) leased to tenant-owners on a straight rental basis, the amount of rent is established by its market value and the tenant is billed therefor on a monthly basis. Of course, this and all other forms of income are offsets to the budgeted expenditures. It is essential that this budget be accurately prepared, because it is the basis for fixing the amount of the proprietary rent referred to above. This rent must be in such an amount as will meet all known and anticipated expenditures and, at the same time, include a margin of safety to cover extraordinary items.

The net amount of the budgetary requirement is next divided by the total number of shares outstanding to ascertain the pro-rata charge per share. Each tenant-owner is then assessed in an amount equal to the number of shares assigned to his apartment multiplied by this prorated charge per share. One-twelfth of this annual assessment is then billed to the tenant each month, or one-quarter thereof every three months.

The bill to the tenant-owners for the monthly assessment is often analyzed in detail, in order to indicate the various components thereof. Since the tenant-owner is entitled to deduct on his income tax return the amounts of taxes and interest paid by him, it is necessary that a record be kept disclosing the amounts of these items included in his annual assessment. It is good policy also to indicate specifically on the monthly bills the amount of amortization included in the charge, for the information of the tenant-owners.

Billing Control and Procedures

A form must be set up to control the monthly billings to accounts receivable. It should contain the following information: Space occupied, name of tenant, number of shares, and total monthly billing. Also, the amounts of any direct charges to tenants, pro-rated amortization payments, etc.

This form may be kept in a columnar arrangement, using a column for each month; however, it will be unnecessary to repeat the regularly recurring monthly entries after the initial tabulation, until some change is made in the amount of the fixed billing. It is a good plan to use two or more lines for each space unit, to enable changes to be made in the name of the tenant-owner if a sale of the apartment is consummated. The total of these monthly charges is an element in the control of accounts receivable for fixed charges or assessments.

The use of an automatic addressing machine will be found to be of great help in preparing the bills showing the name of the tenant-owner and the regular monthly billing charge. After the bills have been stamped out by the machine any other miscellaneous or sundry charges to be billed may be entered by typewriter, the amounts being added while the bill is still in the machine and the grand total then recorded on the bill. There are many charges which may be paid for the account of tenants, and it is important that these items be charged to their accounts as promptly as possible.

Many charges to tenants originate in charge vouchers, prepared in duplicate by the Superintendent's department, to cover items delivered from the stock of supplies on hand. These charge vouchers should not be allowed to accumulate, but should be posted promptly to the tenants' accounts when received in the Accounting Department. One copy of each voucher should be sent to the tenant with his monthly bill, in explanation of the charge.

A listing of the total of all tenants' bills may then be taken and the total checked with the monthly control as established, giving consideration to any arrears, prepayments, and sundry charges.

It is a good plan to have the bills printed in such shape and size that they may easily be inserted in a window envelope, thus eliminating the necessity for separately writing and addressing envelopes therefor.

Tenants' Accounts Receivable and Related Procedures

Records of individual accounts with tenant-owners may be kept on any of the usual forms for accounts receivable. However, the record keeping may be considerably simplified by proper design of the ledger sheets or cards. In our office, we like the idea of having the cards printed with captions to guide the monthly billings, so that there is no unnecessary writing each month. The form should be ruled in monthly columns and receipts are posted directly to the account simply by noting the date paid. We find that there is a great saving of time in keeping the record in this manner, instead of in the usual debit and credit style of ruling.

When the checks are received they are collated and, if any check is received without a bill, a memorandum record is made up for our purposes. The checks are carefully scrutinized for dates, signature, etc., and the bank on which the check is drawn is recorded

on the bill. The bank deposit slip is then prepared, in duplicate, on an adding machine, the copy being attached to the group of bills covering the deposits for the day. This amount is thereupon recorded by the bookkeeper as the amount of the day's deposit; it should, of course, be checked against the corresponding deposit as recorded in the bank pass-book. If any tenant requests a receipt, the original bill is properly receipted before the bills are grouped together and a memorandum record thereof is substituted for the bill. These bills, together with the attached copy of the deposit slip, are then delivered to the accounts receivable bookkeeper for posting to the proper accounts.

As explained before, since the amounts have already been set up in the accounts receivable record, it is necessary to post only the date on which the payment has been received, unless the payment is only a part-payment, that is, less than the amount billed, or is a prepayment in excess thereof. These bills together with the related deposit slip are then filed chronologically for the permanent record.

At the end of the month a list of arrears must be prepared, the total of which must be in agreement with the control figure, which is the difference between the total of the accounts receivable balances at the beginning of the month plus the current charges and less the total of collections, allowances or cancellations during the month.

Vendors' Accounts Payable and Related Procedures

When ordering materials, supplies, or work in connection with the operation of the premises it is important that a properly authorized order be issued for the purpose. The original is sent to the vendor and a copy to the Superintendent of the building, who returns it to the Accounts Payable Division of the Accounting Department with proper delivery receipts, after having approved it as to the receipt of the material or supplies or satisfactory completion of work.

When the bill is received by the Accounts Payable Division, it is attached to the office copy of the order and the Superintendent's approved copy thereof which, as noted above, has been returned to the office. It is then carefully audited and passed to the supervisor of the property for approval. If any of these charges are incurred for the benefit of a particular tenant and are to be charged to him, the Superintendent prepares, in duplicate, a copy of a "Tenant Charge" and sends it to the Accounts Receivable Division for immediate charge to the tenant's account.

After the bill has been approved by the supervisor of the building and returned to the Accounts Payable Division, the copies of the order are properly stamped "Passed for Payment" with date, and two copies are placed in separate files, one in the numerical file and one in the property file. The bill has in the meantime been marked as to distribution by an account number, and then passed to the bookkeeper for payment.

Checks in payment of bills are recorded by the bookkeeper in the cash disbursements book, showing the account to which it is to be charged. It is important that all the bills received during the month be paid in the current month, thereby eliminating the need for keeping the voucher register. There is no need for requesting a receipted bill from the vendor unless it is required by the tenant-owners.

Owner's Ledger

The accounts generally maintained in the owning corporation's ledger include the following:

Assets: Cash in Banks, Accounts Receivable, Other Receivables, Land, Building (contra: accumulated depreciation), Building Improvements (contra: accumulated depreciation and/or amortization), Furniture and Fixtures (contra: accumulated depreciation), Prepaid Items.

(Concluded on page 514)

Net Saving in Estate Taxes for New York Residents Through Use of the Marital Deduction[1]

By Herman Burstein

It is possible to lose rather than save money on estate taxes by using the marital deduction feature of the federal Revenue Act of 1948. On the other hand, in different circumstances, the marital deduction can effect very large savings. These statements are based upon the concept of *net* saving, which takes into account the federal and New York taxes payable on amounts transferred to the surviving spouse when that spouse dies.

When the 1948 Revenue Act was passed, it seemed at first that the marital deduction feature would necessarily produce substantial tax savings on sizable estates. But this hasty impression quickly gave way to the realization that later taxes upon amounts transferred to the surviving spouse would to some degree offset or even exceed the original saving in taxes on the decedent's estate. In other words, many estates that were subject to only one set of taxes under procedures employed in light of the old law have become subject to two sets of taxes under procedures followed in light of the present law.

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Dr. Burstein received an M. A. in Economics from Oberlin College in 1941, and his Ph.D. in Economics from New York University in 1945.

The following discussion deals first with the marital deduction's saving in taxes on the decedent's estate. Then it inquires into the net savings consequent upon additional taxes payable on the estate transferred to the surviving spouse.

The 1948 Act permits one to deduct from gross estate the value of transfers to the surviving spouse up to one-half the adjusted gross estate.[2] Table 1 shows for various selected levels of adjusted gross estate the saving in federal tax on the decedent's estate through maximum use of the marital deduction. It is assumed in the table that there are no deductions for charitable bequests or property previously taxed. Otherwise the savings would be less than shown, depending upon the amount of such deductions.[3]

[1] This note is intended to apply only to residents of New York State or of states with the same schedule of estate tax rates, because the discussion deals with the New York estate tax payable on amounts transferred to the surviving spouse when that spouse dies.

[2] Adjusted gross estate may be defined as gross estate less Section 812(b) deductions for expenses, losses, indebtedness, and taxes.

[3] The saving depends upon: (1) the difference in size of taxable estate with and without the marital deduction; (2) the rate of tax upon this difference. Regardless whether there are deductions for bequests and property previously taxed, the difference in size of taxable estate will be constant. However, the rate of tax upon the difference will be lower when deductions are taken for bequests and property previously taxed. For example, assume an adjusted gross estate of $1,000,000 and no deductions other than the maximum marital one. Therefore, the taxable estate is $500,000 and the saving is dependent upon the tax rates on the portion of estate between $500,000 and $1,000,000. Now assume a deduction of $100,000 for bequests. In this case the saving depends upon the difference between a taxable estate of $400,000 and one of $900,000. The rates are lower upon estates in this range, and therefore the amount saved is less.

The following observations hold with respect to Table 1:

1. For values of adjusted gross estate through $120,000 there is no federal tax where full use is made of the marital deduction. In the absence of the marital deduction, adjusted gross estates down to $60,000 are subject to federal estate tax.
2. Persons in the lower estate brackets save the greatest percentage of tax. Saving as a percentage of the tax that would be paid in the absence of the marital deduction ranges from 100 percent to 50 percent.
3. Persons in the upper estate brackets save the greatest percentage of their adjusted gross estate. Saving as a percentage of adjusted gross estate reaches a maximum of 30.5 percent, beginning with adjusted gross estates having a value of $15,000,000.
4. Points 2 and 3 are not contradictory. Inasmuch as the highest estate brackets are subject to the highest tax rates, any saving must restore to a high estate bracket a larger percentage of the value of the estate than in the case of a low estate bracket.

To determine the federal estate tax saving where deductions for charitable bequests and property previously taxed are taken and/or where the exact value of gross adjusted estate is not given in Table 1, reference should be had to Table 2, which permits rapid computation of federal estate tax.[4] By computing federal estate tax for taxable estate inclusive and exclusive of marital deduction, and taking the difference between the two taxes, the actual saving is obtained.

Table 1 or 2 indicates the true federal estate tax saving through use of the marital deduction only if the surviving spouse, henceforth called S, completely consumes the principal of the estate transferred by the deceased spouse, henceforth called D. However, if the former does not consume the full amount of transferred estate, then the original saving which takes place upon D's death is reduced upon S's death by the increase in federal and New York estate taxes attributable to the property received from D. This increase in taxes is based upon the premise that under the old law the property representing D's marital deduction would have gone to S in the form of a life estate, whereas under the 1948 Act, in order for D to obtain the privilege of the marital deduction, it is generally necessary that the transferred property be left to S in such form that it is included in S's estate for estate tax purposes. Upon S's death federal and New York estate taxes are payable upon the amount transferred by D to S, whereas no taxes are due if S merely owns a life estate.

The "net" saving through use of the marital deduction may be defined as the saving in federal tax upon D's death less the increase in federal plus New York taxes upon S's death. Table 3 enables one to determine the increase in federal plus New York estate taxes resulting from the transfer to S of property which in the absence of the federal marital deduction would be left as a life estate and therefore would not be taxable upon S's death. This table permits rapid calculation of federal plus New York estate taxes upon any amount of taxable estate containing no marital deduction—in the present instance, upon the surviving spouse's estate. Using Table 3, one may obtain

[4] Table 2 can be employed to indicate the saving in federal estate tax which results from charitable bequests. The percentage column shows tax rates on the various portions of an estate. These rates are equivalent to the saving on any bequest taken as a deduction. For example, on an adjusted gross estate of $1,000,000 a bequest of $100,000 would yield a tax saving equal to 31.4 percent of the value of the bequest. An additional bequest of $90,000 would save 32.2 percent of the value of the gift. For estates in the upper brackets, it is possible to achieve tax savings as high as 62.4 percent of the value of the bequest.

the combined tax upon "total estate"—defined as S's original estate plus estate received from D—and then obtain the combined tax upon S's original estate. The difference in taxes is attributable to the transfer of property to S.

To illustrate use of Tables 2 and 3 in arriving at the net estate tax saving through use of the marital deduction. assume that D has an adjusted gross estate of $1,000,000, has no deductions for charitable bequests or property previously taxed, and takes the maximum marital deduction, leaving a taxable estate of $500,000. Assume that S has an original taxable estate of $100,000. Net saving or loss based on these assumptions is calculated in Example 1.

EXAMPLE 1

1) D's federal tax on $1,000,000 under old law	$270,300
2) D's federal tax on $500,000 under 1948 Act	116,500
3) D's saving on federal estate tax (1-2)	$153,800
4) S's federal plus N. Y. taxes on total estate of $600,000	$164,200
5) S's federal plus N. Y. taxes on original estate of $100,000	5,800
6) S's increase in estate taxes (4-5)	$158,400
7) Net saving or (loss) in estate taxes (3-6)	$ (4,600)

It is to be seen in Example 1 that full use of the marital deduction may result in a net estate tax increase rather than decrease if the surviving spouse has an original estate and if no amount of the estate received from the decedent spouse is consumed.

Let us consider the net saving that would result if D used a marital deduction of only $300,000, leaving a taxable estate of $700,000.

EXAMPLE 2

1) D's federal tax on $1,000,000 under old law	$270,300
2) D's federal tax on $700,000 under 1948 Act	176,700
3) D's saving on Federal estate tax (1-2)	$ 93,600
4) S's federal plus N. Y. taxes on total estate of $400,000	$ 97,200
5) S's federal plus N. Y. taxes on original estate of $100,000	5,800
6) S's increase in estate taxes (4-5)	$ 91,400
7) Net saving in estate taxes (3-6)	$ 2,200

It may be surmised from Example 2 that the greatest net saving can be obtained only by less than maximum use of the marital deduction where it is the intent of the surviving spouse to keep intact the estate received from the deceased spouse.

The optimum marital deduction which yields the maximum net saving in estate taxes may be found by use of Tables 2 and 3. The principle employed is to subtract from D's estate (within limits of the marital deduction provision) amounts which will be taxed at lower combined federal plus New York rates when included in S's estate. The percentage columns in Tables 2 and 3 indicate the "marginal" rate of tax, that is, the rate of tax on the last dollar of the taxable estate. It is necessary by trial and error to subtract given amounts from D's estate and add equal amounts to S's estate until the marginal rate per Table 2 (federal estate tax) no longer exceeds the marginal rate per Table 3 (combined federal plus New York estate taxes).

Assuming as before that D has an adjusted gross estate of $1,000,000 and that S has an original taxable estate of $100,000, Example 3 illustrates the method of finding the optimum marital deduction.

EXAMPLE 3

Deceased Spouse Taxable Estate	Marginal Rate[a]	Surviving Spouse Taxable Estate	Marginal Rate[b]
$1,000,000	31.4%	$100,000	19.0%
900,000	32.2	200,000	30.4
810,001	32.2	289,999	30.6
810,000	30.2	290,000	30.6
809,999	30.2	290,001	30.6

[a] Source: Table 2.
[b] Source: Table 3.

The optimum marital deduction in Example 3 is $190,000 (which added to S's original estate of $100,000 gives a total taxable estate of $290,000). The next dollar added to S's estate would be taxed at 30.6 percent, whereas it would be taxed at only 30.2 percent if left in D's estate. If a marital deduction under $190,000 is taken, the last dollar of D's estate would be taxed at 32.2 percent, whereas it would be taxed at only 30.6 percent if included in S's estate.

Example 4 shows a net saving of $4,640 based on the optimum marital deduction of $190,000, employing the same assumptions that underly the previous examples.

EXAMPLE 4

1) D's federal tax on $1,000,000 under old law	$270,300
2) D's federal tax on $810,000 under 1948 Act	209,920
3) D's saving on federal estate tax (1-2)	$ 60,380
4) S's federal plus N. Y. taxes on total estate of $290,000	$ 61,540
5) S's federal plus N. Y. taxes on original estate of $100,000	5,800
6) S's increase in estate taxes (4-5)	$ 55,740
7) Net saving in estate taxes (3-6)	$ 4,640

If it is the intent of the surviving spouse to consume part of the estate, the same type of calculation as in Example 3 may be carried out in order to find the optimum marital deduction, except that the marginal rate on S's estate is based upon total estate less the amount consumed—that is, upon the ultimate taxable estate. Assume that D has an adjusted gross estate of $1,000,000 and contemplates no deductions for charitable bequests or property previously taxed, that S has an adjusted gross estate of $100,000, and that it is S's intent to consume $200,000 of estate.

EXAMPLE 5

Deceased Spouse Taxable Estate	Marginal Rate[a]	Surviving Spouse Taxable Estate	Marginal Rate[b]
$1,000,000	31.4%	$ 0	0%
900,000	32.2	0	0
800,000	30.2	100,000	19.0
700,000	31.0	200,000	30.4
600,000	31.0	300,000	30.6
590,001	31.0	309,999	30.8
590,000	31.0	310,000	30.8
589,999	31.0	310,001	32.8

[a] Source: Table 2.
[b] Source: Table 3.

In Example 5 the optimum marital deduction is $410,000. An additional dollar of deduction would be taxed at 32.8 percent in S's estate and at only 31.0 percent in D's estate. A dollar less of deduction would be taxed at 31.0 percent in D's estate and at only 30.8 percent in S's estate. Example 6 shows a net saving of $60,020 on the basis of the assumptions underlying Example 5 and using the marital deduction of $410,000.

EXAMPLE 6

1) D's federal tax on $1,000,000 under old law	$270,300
2) D's federal tax on $590,000 under 1948 Act	142,600
3) D's saving on federal estate tax (1-2)	$127,700
4) S's federal plus N. Y. tax on total estate of $310,000	$ 67,680
5) S's federal plus N. Y. tax on original estate of $0	0
6) S's increase in estate taxes (4-5)	$ 67,680
7) Net saving in estate taxes (3-6)	$ 60,020

Table 1

FEDERAL ESTATE TAX SAVING ON DECEDENT'S ESTATE THROUGH MAXIMUM USE OF MARITAL DEDUCTION

Adjusted Gross Estate	*Tax Saving*[a]	*Percent of Saving to Adjusted Gross Estate*	*Percent of Saving to Former Tax*
$ 60,000	$ 0	0.0%	—
65,000	150	0.2	100.0%
70,000	500	0.7	100.0
75,000	1,050	1.4	100.0
80,000	1,600	2.0	100.0
85,000	2,300	2.7	100.0
90,000	3,000	3.3	100.0
95,000	3,900	4.1	100.0
100,000	4,800	4.8	100.0
105,000	5,860	5.6	100.0
110,000	6,920	6.3	100.0
115,000	8,130	7.1	100.0
120,000	9,340	7.8	100.0
125,000	10,625	8.5	99.3
130,000	11,910	9.2	98.8
140,000	14,280	10.2	96.6
150,000	16,450	11.0	94.0
175,000	21,750	12.4	89.1
200,000	26,700	13.4	84.8
225,000	30,875	13.7	80.4
250,000	34,600	13.8	76.4
275,000	38,100	13.9	73.0
300,000	41,600	13.9	70.4
350,000	48,900	14.0	66.7
400,000	56,200	14.1	64.1
450,000	63,700	14.2	62.4
500,000	71,200	14.2	61.1
600,000	86,600	14.4	59.4
700,000	103,400	14.8	58.5
800,000	119,200	14.9	57.6
900,000	136,800	15.2	57.3
1,000,000	153,800	15.4	56.9
1,250,000	197,950	15.8	56.3
1,500,000	246,800	16.5	56.3
1,750,000	301,250	17.2	56.6
2,000,000	356,300	17.8	56.9
2,500,000	478,600	19.1	57.7
3,000,000	610,800	20.4	58.2
3,500,000	748,300	21.4	58.4
4,000,000	895,800	22.4	58.8

Table 1—(Continued)

FEDERAL ESTATE TAX SAVING ON DECEDENT'S ESTATE THROUGH MAXIMUM USE OF MARITAL DEDUCTION

		Percent of Saving to	
Adjusted Gross Estate	*Tax Saving*[a]	*Adjusted Gross Estate*	*Former Tax*
$ 4,500,000	$ 1,052,300	23.4%	59.1%
5,000,000	1,208,800	24.2	59.3
5,500,000	1,373,300	25.0	59.4
6,000,000	1,537,800	25.6	59.4
6,500,000	1,707,800	26.3	59.5
7,000,000	1,877,800	26.8	59.5
7,500,000	2,053,300	27.4	59.4
8,000,000	2,228,800	27.9	59.4
8,500,000	2,407,900	28.3	59.3
9,000,000	2,586,400	28.7	59.2
9,500,000	2,761,700	29.1	59.1
10,000,000	2,936,200	29.4	59.0
11,000,000	3,273,000	29.8	58.6
12,000,000	3,608,000	30.1	58.2
13,000,000	3,933,000	30.3	57.8
14,000,000	4,257,000	30.4	57.4
15,000,000	4,571,000	30.5	57.0
16,000,000	4,884,000	30.5	56.6
17,000,000	5,187,000	30.5	56.1
18,000,000	5,489,000	30.5	55.7
19,000,000	5,794,200	30.5	55.4
20,000,000	6,100,200	30.5	55.1
25,000,000	7,625,000	30.5	54.0
50,000,000	15,250,000	30.5	51.9
75,000,000	22,875,000	30.5	51.3
100,000,000	30,500,000	30.5	50.9
200,000,000	61,000,000	30.5	50.5
300,000,000	91,500,000	30.5	50.3
400,000,000	122,000,000	30.5	50.2
500,000,000	152,500,000	30.5	50.2

[a] The saving shown assumes no deductions for charitable bequests or property previously taxed. In the event that such deductions are applicable, the saving would be less than shown.

Table 2

COMPUTATION OF FEDERAL ESTATE TAX

Taxable Estate[a]		Federal Estate Tax[b]	
From	*To*	*Amount in this column Tax = +*	*% of excess over amount in first column*
$ 0	$ 60,000	$ 0	0
60,000	65,000	0	3
65,000	70,000	150	7
70,000	80,000	500	11
80,000	90,000	1,600	14
90,000	100,000	3,000	18
100,000	110,000	4,800	21.2
110,000	120,000	6,920	24.2
120,000	150,000	9,340	27.2
150,000	160,000	17,500	26.4
160,000	200,000	20,140	28.4
200,000	300,000	31,500	27.6
300,000	310,000	59,100	26.8
310,000	500,000	61,780	28.8
500,000	560,000	116,500	28.0
560,000	700,000	133,300	31.0
700,000	810,000	176,700	30.2
810,000	900,000	209,920	32.2
900,000	1,060,000	238,900	31.4
1,060,000	1,100,000	289,140	33.4
1,100,000	1,310,000	302,500	32.6
1,310,000	1,560,000	370,960	35.6
1,560,000	1,600,000	459,960	38.6
1,600,000	2,060,000	475,400	37.8
2,060,000	2,100,000	649,280	41.8
2,100,000	2,560,000	666,000	41.0
2,560,000	2,600,000	854,600	45.0
2,600,000	3,060,000	872,600	44.2
3,060,000	3,100,000	1,075,920	47.2
3,100,000	3,560,000	1,094,800	46.4
3,560,000	3,600,000	1,308,240	49.4
3,600,000	4,060,000	1,328,000	48.6
4,060,000	4,100,000	1,551,560	52.6
4,100,000	5,060,000	1,572,600	51.8
5,060,000	5,100,000	2,069,880	55.8
5,100,000	6,060,000	2,092,200	55.0
6,060,000	6,100,000	2,620,200	58.0
6,100,000	7,060,000	2,643,400	57.2
7,060,000	7,100,000	3,192,520	60.2
7,100,000	8,060,000	3,216,600	59.4
8,060,000	8,100,000	3,786,840	62.4
8,100,000	9,100,000	3,811,800	61.6
9,100,000	10,060,000	4,427,800	60.8
10,060,000	10,100,000	5,011,480	61.8
10,100,000	....	5,036,200	61.0

[a] Taxable estate consists of gross estate less allowable deductions for administration expenses, charitable bequests, transfers to surviving spouse, and property previously taxed.

[b] Tax shown is based on full credit of 80 percent of "basic tax" for state tax purposes.

Table 3

COMBINED FEDERAL AND NEW YORK ESTATE TAXES ASSUMING NO MARITAL DEDUCTION

Taxable Estate[a]		Combined Estate Tax[b]	
From	To	Amount in this column Tax =	+ % of excess over amount in first column
$ 0	$ 60,000	$ 0	1.0
60,000	65,000	600	4.0
65,000	70,000	800	8.0
70,000	80,000	1,200	12.0
80,000	90,000	2,400	15.0
90,000	100,000	3,900	19.0
100,000	110,000	5,800	22.2
110,000	120,000	8,020	25.2
120,000	150,000	10,540	28.2
150,000	160,000	19,000	28.4
160,000	200,000	21,840	30.4
200,000	300,000	34,000	30.6
300,000	310,000	64,600	30.8
310,000	500,000	67,680	32.8
500,000	560,000	130,000	33.0
560,000	700,000	149,800	36.0
700,000	810,000	200,200	36.2
810,000	900,000	240,020	38.2
900,000	1,060,000	274,400	38.4
1,060,000	1,100,000	335,840	40.4
1,100,000	1,310,000	352,000	40.6
1,310,000	1,560,000	437,260	43.6
1,560,000	1,600,000	546,260	46.6
1,600,000	2,060,000	564,900	46.8
2,060,000	2,100,000	780,180	50.8
2,100,000	2,560,000	800,500	51.0
2,560,000	2,600,000	1,035,100	55.0
2,600,000	3,060,000	1,057,100	55.2
3,060,000	3,100,000	1,311,020	58.2
3,100,000	3,560,000	1,334,300	58.4
3,560,000	3,600,000	1,602,940	61.4
3,600,000	4,060,000	1,627,500	61.6
4,060,000	4,100,000	1,910,860	65.6
4,100,000	5,060,000	1,937,100	65.8
5,060,000	5,100,000	2,568,780	69.8
5,100,000	6,060,000	2,596,700	70.0
6,060,000	6,100,000	3,268,700	73.0
6,100,000	7,060,000	3,297,900	73.2
7,060,000	7,100,000	4,000,620	76.2
7,100,000	8,060,000	4,031,100	76.4
8,060,000	8,100,000	4,764,540	79.4
8,100,000	9,100,000	4,796,300	79.6
9,100,000	10,060,000	5,592,300	79.8
10,060,000	10,100,000	6,358,380	80.8
10,100,000	....	6,390,700	81.0

[a] Taxable estate consists of gross estate less allowable deductions for administration expenses, charitable bequests, and property previously taxed.

[b] The amount of federal tax is based on full credit of 80 percent of "basic tax" for state tax purposes. The amount of New York State tax is before exemptions taxed at one percent.

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

Consulting Economist—Is this a Profession Exempt from the Unincorporated Business Tax—A taxpayer derives his income from his activities as a consulting economist. Is he engaged in an unincorporated business subject to the unincorporated business tax or does he render services in the practice of a profession exempt from this tax?

The statute (Sec. 386) exempts four enumerated professions (law, medicine, dentistry and architecture) principally for the reason that these professions may not be conducted under corporate structure. The statute also exempts *'any other case'* (profession?) if more than eighty per cent of gross income is derived from the personal services actually rendered by the individual and capital is not a material income producing factor.

The official questions (#6) say that a profession "includes any occupation or vocation in which a professed knowledge of some department of science or learning is used by its practical application to the affairs of others."

The consulting economist has acquired increased importance in recent years. In the field of taxation he is called on to establish the economic background essential to determine the proper application of many sections of the law, for example excess profits tax relief under Section 722, unreasonable accumulation of a surplus under Sec. 102, reasonable salaries under Sec. 23, etc. The determination of income is an economic concept as well as an accounting concept or legal concept.

In other fields of our economy, also, the consulting economist has been called upon to render services quite analogous to those of the accountant or the attorney.

It is not farfetched to say that a new profession is in the making, if it has not already been established. In our opinion, the consulting economist should be recognized by the Tax Commission as a profession exempt from the Unincorporated Business Tax. A literal interpretation of the statute and the official questions should exempt any occupation or vocation from the unincorporated business tax if more than 80% of the gross income is derived from personal services and capital is not a material income producing factor. The official questions state that the occupation must be one in which a knowledge of some department of learning is applied practically. The consulting economist is literally within the terms of the statute and official questions. His professed knowledge is principally in the field of political economy. It usually encompasses also other fields such as accounting, law and

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taxation, and this knowledge is applied to the specific problems of the client engaging the services of the economist.

Vocation of Investment Counsel—In 1936, the Tax Commission issued a ruling that the vocation of investment counsel while it requires training, knowledge, and experience is not knowledge in a learned field and, therefore, an investment counsel is subject to the unincorporated business tax. This question came before the court in *People ex rel Dewey* v. *Browne*[1] and the Court held that the service rendered by an investment consultant is not the practice of a profession within the meaning of the exemption in Sec. 386 of the Tax Law.

It is probably on the basis of this decision that the Commission seeks to subject the consulting economist to the Unincorporated Business Tax.

Gross Receipts Tax — Duplicate Taxation—In 1947, the State Legislature passed an enabling act authorizing counties and cities to impose taxes for the privilege of carrying on business in those counties and cities (gross receipts tax). The law also provided that if a method of allocation of receipts adopted by any county or city results in the taxation of such receipts by more than one city or county, the State Tax Commission may direct a revision of such method of allocation in order to eliminate double taxation of such receipts.

The City of New York has adopted a gross receipts tax, and so has the County of Monroe. The methods of allocation of receipts by New York City and the County of Monroe result in double taxation, since receipts from sales shipped from the County of Monroe to New York City or from New York City to the County of Monroe are taxable in both places. The State Tax Commission in a special ruling has directed New York City and the County of Monroe to revise their methods of allocation so that sales of goods shipped to either place from a point within the State of New York shall be non-allocable and non-taxable if the seller is subject to a general business tax on such receipts at the point from which the shipment is made. The revision is applicable to any return previously filed if a timely application for refund is filed.

The Property Factor in the Allocation Formula—Rented Property—Last month we commented on the 1949 amendment to Sec. 210 of Article 9-A, which made property rented by a taxpayer a part of the property factor in allocating business income. On May 26, the Federal Tax Forum devoted an evening to a discussion of the many problems that will confront the Tax Commission in formulating regulations to make the new provision effective.

The allocation formula consists of three fractions separately computed, the average of the three fractions constituting the percentage to be used in determining income attributable to New York. One of these fractions is the average value of real and tangible personal property within the state to the average value of real and tangible personal property everywhere. It is this fraction that is affected by the amendment to the law requiring a taxpayer to include in it the value of real property rented by him. Prior to the amendment if a corporation, for example, rented a factory in New Jersey the value of that property was excluded from the denominator of the property fraction and the rental of the factory therefore was given no consideration in allocating some of the business income outside the state. The effect of the amendment in the example cited is to increase the denominator of the property fraction and thus reduce the final allocation percentage to determine income subject to tax in New York. If the corporation rented a factory in New York the numerator of the property

[1] 269 App. Div. 887 (1945).

fraction is increased also and hence more income will be subject to tax in New York. But the basic problem remains. How should rented property be valued and should all rented property be included?

The law itself would seem to include all rented property. It has been suggested that executive and administrative offices should be excluded from this factor. But the executive and administrative aspects of a business are an important part of the activities of the business and if a corporation is engaged in business within and without the state, the location of executive and administrative activities should be given some weight in allocating the income of the business. Where New York is the major center of the executive and administrative activities, the effect of the amendment will be to increase the income subject to tax in New York. Under the salary factor, executives' salaries are excluded both from the numerator and denominator of the fraction. This may be some precedent for a similar exclusion of property rented for executive and administrative offices.

It has also been suggested that rentals paid for space in public or private warehouses should be excluded from this factor. If the public warehouse is used regularly by the corporation in carrying on its business, the warehouse becomes a regular place of business and the corporation acquires a right to an allocation, at least under the property factor. Logically, since the rental of warehouse space establishes a right to allocate, that fact should enter into the determination of how much of the income is to be allocated within and without the state. We should favor the capitalization of warehouse rent by a factor of 3 or 4 to determine the average value of the warehouse property used within or without the state.

Perhaps, from the administrative standpoint, the simplest method to give effect to the inclusion of rented property in the property fraction is to include in the numerator or denominator of the fraction the actual annual rent paid for the use of the property. Where property is rented both within and without the state such method will give a fair result. If, however, the corporation owns property within the state and rents property without the state, or vice versa, this method would distort the allocation fraction. In such cases the annual rent should be capitalized by a factor between 4 and 10 depending upon the location of the property. This factor need not be fixed. It could vary from year to year and from place to place and would give effect to equalization of rental values between a location like New York where rentals are usually high and other areas where rentals are lower.

Since the property factor is one of three fractions to be averaged and since the question of valuation of rented property is one concerning which there can be valid divergent opinions, the taxpayer should be given wide latitude in determining the average value of rented real property. It has been suggested that the assessed value of property be used. Under Sec. 182 of article 9-A, the tax of ¼ of a mill on gross assets is based upon assessed values if those are greater than book values. The corporation should be given the option of using assessed values. Where there is some distortion in assessed values within and without the state some equalization factor may be used by the taxpayer. The taxpayer should have the option of using appraised values, or book values.

The capitalization by a factor of X times the annual rent raises some additional questions. Should gross rents or net rents be used? The primary concern is simplicity of administration. Therefore gross rents should be used as the basis for capitalization. The use of net rents would raise questions of what items should be taken into account as deductions from gross rents to determine net rents. No serious distortion can result since the capitalization

factor based upon gross rents would normally be less than the factor based upon net rents. Perhaps this question, too, could be left to the option of the taxpayer corporation.

It has been suggested that since rentals under old leases are lower than those under new leases some equalization factor should be provided in determining valuation based upon capitalization by the use of gross or net rents. If there is any distortion because of new and old leases the regulations should provide for an equalizing factor. This too could be optional with the taxpayer.

The duration of a lease is a factor in the determination of value and the taxpayer should be permitted to give consideration to this factor at his option. What effect, if any, should be given to improvements made to leased premises? Perhaps the simplest method of treating such improvements is to write off the improvements as rent over the term of the lease.

Further Suggestions for a Proposed Regulation on Rented Property—The thought has been expressed that the amendment to Section 210 on the inclusion of rented property in the allocation formula was drawn too broadly. In the majority of cases the property factor in the allocation formula achieved an approximation that worked satisfactorily. The time and effort required to apply the new provision with respect to rented properties will not in a great many instances be commensurate with the resulting difference in tax. It is therefore suggested that consideration be given to further amendment of the statute to provide for a limited application of the provision. For example, rented real property should be included in the property factor only if the taxpayer occupies a substantial part of a building, say at least 50%.

Another suggestion is that rented real property should be included in the property factor in the discretion of the Tax Commission. The Commission would allow the inclusion of rented property if such property was a material factor in the allocation percentage. If not material the taxpayer would not be concerned with the complexities involved in the valuation problems. Such a provision would eliminate those taxpayers who maintain administrative and executive offices in a relatively small part of an office building and, also, those who rent inconsequential space in a warehouse.

There have been varied proposals for valuing rented property. One suggestion is that the landlord's valuation be used and an allocable portion be determined for the taxpayer lessee. This method preserves the method used for owned property. It may, however, be difficult to obtain the valuation used by the landlord. The landlord may be reluctant to divulge such information to his tenant.

In addition to the use of assessed value of the landlord's property as a basis, book values and appraised values have been suggested. Each tenant could allocate the value of the rented property on the basis of square feet used by him or on the basis of the rent paid.

Valuation on the basis of capitalization of rental costs requires no information from a landlord. However it may not achieve a real approximation of value. In determining rental cost, interest, taxes and insurance, should be included if the lessee is required to pay these under the lease. The capitalization factor to be used varies with each suggestion. If a single factor is to be used, the Commission should have available a study of the ratio of rent to value over a representative period of time, one preferably that includes both a rising and falling real estate market. If administrative simplicity is sought, then geographic variation might be ignored.

It was felt that the case of a lease with an option to purchase presented some difficulty, as also the case where rentals could be applied against the

purchase price. This situation may require special treatment and should therefore not be included in a general regulation.

Should rented property be separately considered as a fourth fraction in the allocation formula? If so, what weight should be given to this factor in relation to the other three? If we asume that the three factors now used achieve a fair allocation, then an additional "occupancy cost" factor should be given a weight of 1/6 in the property factor with "other tangible property" the other 1/6.

If landlord and tenant are included in a combined report the rented property should be eliminated.

Federal Changes in Net Income—Whenever the Commissioner of Internal Revenue changes the net income of a taxpayer for any year, the taxpayer must notify the Tax Commission of the changes within 90 days after a final determination (Art. 571(a)). No special form is prescribed, but the notification must be accompanied by a copy of the final federal determination. The taxpayer must either concede the accuracy of the Commissioner's determination or state wherein it is erroneous. The notification is required regardless of whether the taxpayer believes the change will affect his tax liability to the State.

Under Sec. 367.2 a taxpayer who files an amended federal return must, within 90 days thereafter, file an amended return with the State Tax Commission.

A non-resident is not required to notify the Commission of a federal change in his net income, or to file an amended return unless the changes or amendments relate to income taxable to a non-resident.

The Tax Commission is limited to one year after the receipt of a notification of a federal change in net income or the receipt of an amended return within which to recompute the tax and issue an assessment or refund. If no notification is sent or amended return filed, the tax may be recomputed at any time without any limitation. In the latter situation no refund will be made should the taxpayer be entitled to one. Nor is the Tax Commission required to accept as correct the changes made by the Commissioner of Internal Revenue. It may make its own independent determination.

What is a Final Determination?—The Regulations say that "a final determination is an irrevocable determination or adjustment . . . from which there exists no further right of appeal either administrative or judicial." A closing agreement under Sec. 3760 of the Internal Revenue Code is such a final determination. An allowance of a refund by the Commissioner or the assessment of a deficiency is a final determination. The ninety-day deficiency notice issued under Sec. 272(a) of the Internal Revenue Code is a final determination, but if a petition is filed in the Tax Court there is no final determination until there is a judgment of the Court of last resort affirming or modifying the deficiency.

The above provisions are effective on or after July 1, 1949. No additional assessments or refunds my be made if the Statute of Limitations otherwise applicable will have expired by July 1, 1949. Nor may the provisions of Article 571(a) limit the time within which assessments or refunds may otherwise be made.

Use Tax on Cigarettes—Less than 400 cigarettes may be brought into the state personally and for personal use tax-free. But a tax is required on every single pack if any cigarettes are received from another state by mail, express, or shipped in any other manner. The taxpayer is required to notify the Tax Commission of the receipt of the cigarettes and pay a tax of 3¢ a pack or 30¢ a carton. The penalty for non-compliance is heavy: a $50. fine or 30 days in jail. This law was enacted in the last legislature and went into effect on May 1.

Deduction of Franchise Tax—Joe Getz calls our attention to the case of *Hayman Mercantile Co.*,[2] which has a New York tax angle. The income for the year 1944 had been increased by the Tax Court. Such increase resulted in an additional New York franchise tax for the year 1944. The taxpayer claimed that the additional franchise tax should be accrued as a deduction in 1944. The Tax Court held that the additional state franchise tax could not be accrued in 1944, because the liability for the tax came within the category of a contested tax since the income upon which the tax was based was the subject of the very dispute that the Court decided. As the Court put it the State franchise tax cannot be regarded as "so certain in prospect as to have warranted an accrual at that time." Getz points out that according to GCM 25298 a contest of a tax does not necessarily mean taking a case to court, but that a protest lodged with the tax authorities is deemed a contest.

Getz would like to know if the State would follow the Federal view that where there is a contest of a tax, the tax is deductible in the year when the contest is finally resolved and that, therefore, the deduction for the tax would affect the franchise tax liability for the year following the year of deductibility.

Under a ruling of the State Tax Commission dated January 6, 1949, an additional franchise tax under new Art. 9-A is deductible on the report covering the period immediately following that upon which the additional tax was based.[3] In the instant case the additional tax was based upon the entire net income for the year 1944, and under the ruling that additional franchise tax is deductible on the 1945 franchise tax return. The New York law does not in this situation follow the federal rule for the accrual of contested taxes.

Suppose the 1945 year is outlawed because of the Statute of Limitations. This situation was the subject of an amendment to Sec. 212.5 (Chapter 848, Laws of 1949) which provides that to the extent necessary to reflect the adjustment for the deduction of the franchise tax, the Tax Commission may reaudit the accounts for the year the deduction is permitted at any time regardless of the Statute of Limitations.

Stock Transfer Tax—The transfer tax law involving the tax on the transfers of stock from a broker to a customer was amended by the 1949 legislature and became effective July 1, 1949. Under a ruling dated June 2, 1949, the exemption now existing for a transfer by a purchasing broker to a customer for whom the stock was purchased will be limited to cases in which the transfer to the customer on the books of the corporation is made from the broker to the customer. If the certificate is in the name of any person other than the broker, the transfer directly to the customer will no longer be exempt from the stock transfer tax.

But if the tax has been paid to the broker upon the sale of the certificate and proper evidence is furnished to the transfer agent, it will not be necessary to make a double transfer on the books of the corporation, first to the name of the broker and then to the name of his customer. In such a case the transfer may be made directly to the name of the customer for whom the broker made the purchase, and no additional tax need be paid. However the broker-customer relationship must be shown by a proper exemption certificate.

Doing Business—A corporation may be deemed to be doing business within the state so as to be subject to the jurisdiction of the courts of the state and yet not be doing sufficient business so as to be subject to tax in

[2] T.C. Memorandum, November 18, 1948.

[3] New York State Tax Clinic, March, 1949, issue, p. 200.

this state. A recent case[4] involved an action against a foreign corporation which was not qualified to do business in New York and had no branch office in this state. The service of the summons was made upon an officer of a New York corporation which acted as an exclusive purchasing agent for the foreign corporation. The defendant moved to dismiss the complaint on the ground that the state had no jurisdiction over a foreign corporation not doing any business in New York. The court held that the state had jurisdiction over the foreign corporation because the resident buyer was acting here as agent of the foreign corporation. Its local activities were continuous and it was immaterial that those activities were carried on by a separate corporation and not by a directly controlled subsidiary or branch office.

In this case it happens that the New York corporation was an exclusive purchasing agent for the foreign corporation and not an independent resident buyer acting for other purchasers as well. It is the tax aspect however that is of greater interest. A foreign corporation may engage in selling activities within the state and yet not be subject to tax. The question has come up as to the effect of purchasing activities of a foreign corporation within the state. We previously commented on this in the New York State Tax Clinic.[5] This case may be a basis for holding the foreign corporation taxable in New York because of its purchasing activities.

Statute of Limitations — Retail Sales Tax—An application for refund of sales taxes alleged to have been paid erroneously, illegally, or unconstitutionally must be made with the comptroller within one year from the payment of the tax (Administrative Code, sec. N41-8.0, subd. a). But if the comptroller asserts a claim for a deficiency of city sales taxes covering a specific type of transaction for years for which the taxpayer has paid sales taxes on other types of transactions, the taxpayer may set up a claim for refund of taxes on the latter type of transactions against the asserted claim of the comptroller. This is the familiar doctrine of equitable set-off or recoupment. That was the holding of the Court of Appeals in a recent case.[6] The City by its action had reopened the matter of sales tax liability for the entire period in question and that gave the taxpayer an equitable right to plead a recoupment claim for taxes of the same type in the same period. This right of equitable set-off permits the taxpayer to make a claim against the asserted tax. It would not entitle the taxpayer to an actual refund of taxes paid if the set-off exceeded the amount of the claimed deficiency. To that extent the limitation of one year would apply. Two justices dissented from the majority opinion.

The U. S. Supreme Court had occasion to rule on an analogous situation in a case[7] involving income taxes. In that case a taxpayer made a claim for refund of income taxes paid. The Commissioner pleaded that in fact there had been no overpayment of taxes since the taxpayer should have paid an additional tax based upon the disallowance of certain deductions made on the return. Such deductions had not previously been disallowed, and the Commissioner was barred by the Statute of Limitations from asserting the claim at the time the taxpayer made his claim for a refund. The court held that the Commissioner's claim could be set up as an equitable set-off or recoupment to the taxpayer's claim.

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[4] *Sterling Novelty Corp.* v. *Frank & Hirsch Distributing Co., Ltd.*, Court of Appeals, May 26, 1949.

[5] May, 1949, issue; p. 314.

[6] *Matter of National Cash Register Co.* v. *Joseph et al.*, Court of Appeals, May 19, 1949.

[7] *Lewis* v. *Reynolds*, 284 U.S. 281.

Stock Transfer Tax-Effect of Failure to Pay the Tax in a Legal Proceeding—A trustee, acting under a deed of trust, received some stock certificates properly endorsed from the grantor of the trust. The trustee presented the stock certificates to the corporation for transfer on its books to his name as trustee. The corporation refused to transfer the certificates and, in an action brought by the trustee, argued for a dismissal of the complaint on the ground that under Sec. 278 of the Transfer Tax law no action can be maintained on any transfer of certificates if stock transfer tax stamps were not affixed to the certificates at the time they were transferred. The trial court dismissed the complaint. The Appellate Division reversed[8] the trial court on the basis of an earlier case,[9] where the Court of Appeals said,

> "The object of all these tax provisions is to get money for the state. When the only question presented is the right to have stock transferred upon the books of a corporation, the state is fully protected, if the stamps are annexed or the tax paid at or before the time the transfer is made."

The trial court should have required the corporation to produce the certificates in court and to afford an opportunity to the trustee to affix the stamps.

[8] *Hoffman* v. *T. J. Ronan Co., Inc.*, App. Div., 1st Dept., March 29, 1949.
[9] *Lintwieler* v. *Lintwieler P. E. Co.*, 231 N.Y. 494.

Accounting for Cooperative Apartment Buildings

(Continued from page 498)

Liabilities: Accounts Payable, Withholding Taxes Payable, Other Payables, Accrued Expenses, Mortgages Payable.

Capital: Capital Stock, Surplus (Earned, Paid-In, etc.), Surplus Reserves.

Income: Assessments Against Stockholders for Apartments, Rental of Storerooms and Servants' Rooms, Interest, Miscellaneous.

Expenses: Real Estate Taxes, Mortgage Interest, Wages (analyzed as required by owners), Housekeeping Supplies, Plumbing and Electrical Supplies, Heating, Electricity, Repairs and Maintenance Expenses (analyzed as required by owners), Depreciation and Amortization of Facilities, Insurance Charges, Water Charges, Management Fees, Commissions, Legal and Auditing Fees, Office Expenses, and Income, Franchise and Other Taxes.

The 107th New York Certified Public Accountant Examination

May 18, 19 and 20, 1949

THEORY OF ACCOUNTS

Thursday, May 19, 1949—9 a. m. to 12.30 p. m., only

This paper is intended to test the extent of your knowledge of accounting theory and your ability to apply the knowledge you have acquired. Due weight will be given to the arguments presented to support your answer to each question, even though the examiners may not agree with your conclusions.

Answer eight of the following ten questions.

1 Present accounting theory is based on the assumption that the "value of money" is relatively stable. If there is a significant change in the price level, or in the purchasing power of the dollar, problems arise in interpreting income data as determined under conventional accounting procedures.

State and explain briefly the nature of such problems as related to inventories and fixed assets. You need not attempt to offer solutions to these problems. [12½]

2 [12½]

a Considering both balance-sheet valuation and income determination, you are to state and explain the effect upon the financial statements of the use of the last-in-first-out method of determining inventory cost compared with the effect of the first-in-first-out method. You are to assume (1) that the prices have risen during the year, and (2) that prices have fallen during the year.

b State the amount at which you would value product Z at the two year-end dates in the following example and give reasons supporting your answer. The company uses cost or market, whichever is lower. There were no sales or purchases during the period but the item is considered salable and has not deteriorated.

Date	*Original Invoice Price*	*Replacement Market Price*
12-31-47	$12,250	$ 9,300
12-31-48	12,250	10,500

3 Should special assessments on land, (*a*) used in business, (*b*) held for future business use, and (*c*) held for speculation or (*d*) development and resale, be capitalized or charged to expense? State reasons for your reply. [12½]

4 Charges may be made to a fixed asset account for the cost of machinery that is purchased new, for certain replacements, and for certain improvements, betterments and additions to machinery and equipment. However, not all such expenditures are ordinarily capitalized, for example, if they are not material in amount. You are to state and explain *three* other considerations in determining in any given instance whether an expenditure in connection with machinery and equipment should be charged to a fixed asset account or to an expense account. Do not include any income-tax considerations. [12½]

5 [12½] Under some conditions, Federal income-tax regulations require that dividends paid in a company's own stock shall be reported as income to the recipient, whereas under other conditions it need not be so reported.

a Briefly explain this tax regulation.

b State the accounting theory applicable to such dividends and give the reason supporting this theory.

6 A manufacturing concern, which uses an historical cost system and applies manufacturing expense on the basis of "predetermined" or "fixed" rates, has the following accounts on its books at the end of its fiscal year:

Manufacturing Expense (debit)	$217,384
Manufacturing Expense Applied (credit)	182,952
Work-in-process (debit)	70,740
Finished Goods (debit)	115,366
Cost of Goods Sold (debit)	420,294

You are to give *two* acceptable methods of disposing of the $217,384 Manufacturing Expense and the $182,952 Manufacturing Expense Applied balances, and give the arguments for and against *each* method, setting forth any necessary assumptions you make. You need not work out any computations. [12½]

7 Explain a satisfactory method of accounting for containers and container deposits under the following conditions:

A manufacturing company packs and ships its product in containers which cost the company $10.50 each. It bills its customers $12.50 for each container, which amount is refundable upon its return in good condition. It is the experience of the company that 15% of the containers are never returned for refund and that they are useful for an average of 10 shipments, after which they are scrapped with no significant recovery. The company normally owns about 2,000 containers, most of which are in the hands of customers or in transit. Shipments are about 8,000 per year. Containers are to be considered as fixed assets and depreciated. [12½]

8 Give at least *two* reasons which justify the omission of depreciation in preparing financial statements for governmental units such as cities, counties, etc. [12½]

9 The Hilltop Farm Equipment Company sells its products to customers, payable 25% at date of purchase and 25% each year thereafter until paid in full. No interest is charged on the installments if paid when due. State *three* methods that might reasonably be used by the company in reporting income from its sales and state the arguments for and against each method. Your answer is not to be determined by income-tax law or regulations. [12½]

10 [12½]

a State the formula for computing *each* of the following:

(1) Current ratio
(2) Raw material turnover
(3) Finished goods turnover
(4) Average collection time for accounts receivable
(5) Book value per share of common stock

b State the significance of *each* of the above computations as applied to a company engaged in manufacturing.

COMMERCIAL LAW

Friday, May 20, 1949—9 a. m. to 12.30 p. m., only

Except for questions No. 9 through No. 12 in Group II, which are "objective" type questions, reasons must be stated for each answer; no credit will be given for an answer unsupported by a statement of reasons. Whenever practicable, give the answer first and then state reasons. Answers will be graded according to the candidate's evident knowledge of the legal principles involved in the question rather than on his conclusions. Answers to questions involving negotiable instruments, partnerships and sales should be based on the provisions of the pertinent Uniform Law.

Answer the questions as directed under each group.

Group I—Answer all questions in this group.

Negotiable Instruments

1 [10]

a A made and delivered to B his promissory note for $500. Before maturity B agreed with C and D to sell them the note for $500, C to advance $300 and

D $200. B endorsed the note as follows: "Pay to the order of C, $300 and to the order of D, $200." C and D obtained possession of the note but failed to pay any part of the consideration to B. Before maturity of the note C and D endorsed it for value to E, an innocent party without notice. The note not being paid at maturity, E attempted to collect from B, who claimed failure of consideration for his endorsement.

(1) Was E a holder in due course? Why? (2) Did B's endorsement pass title to C and D? Why? (3) Was B's defense maintainable? Why?

b A note began with the words: "One year after date I promise to pay, etc." It was signed by Allen, Burt and Carr respectively. The note was not paid at maturity and the holder sought payment from Carr, who contended that he was not liable until an effort had been made to recover from Allen and then against Burt.

(1) Was Carr correct? (2) Why?

SALES

2 [10]

a Smith sold to Williams a lot of bricks and agreed that the bricks could be removed from Smith's yard at any time that suited the buyer. After the expiration of a year, Smith notified Williams that he desired to have the bricks removed to obtain room in his yard.

(1) Could Smith compel Williams to remove the bricks? Why? (2) What, if any, is the buyer's liability for refusal or neglect to remove the bricks? (3) Can the seller charge for storage? When?

b Allen, having a stock of men's suits on hand, offered to sell them to Burt at $15 each. In the course of the negotiations he said to Burt, "I assure you each suit is worth $25." Relying on this statement Burt purchased the stock and paid for it at $15 for each suit. It turned out that none of the suits was worth more than $10 and Burt was compelled to sell them at a loss. He sought reimbursement from Allen.

(1) Could he recover? (2) Why?

c George agreed to sell and deliver to John certain goods on or before the 15th day of July. Instead of delivering the whole of the goods, he attempted to deliver them in installments, the last installment to be delivered on July 15. John refused to accept the goods.

(1) Was he required to accept the goods? (2) Why?

CONTRACTS

3 [10]

a On December 1, 1948, the Jones Co. and a labor union entered into a contract whereby the Jones Co. agreed to pay, thereafter, wages at a specified rate to its employees who were members of the union. Smith, a member of the union employed by Jones Co. for many years at a lesser rate, was ignorant of the terms of the contract and continued at the old rate. On May 1, 1949, Smith was informed of the terms of the labor union contract and then sued the Jones Co. for the difference between the wages he had received from December 1, 1948, and the wages specified in the labor union contract. The Jones Co. contends that it is not liable to Smith as he was not a party to the contract.

(1) Is the Jones Co. liable to Smith? (2) Why?

b Burns, a contractor, entered into a contract to construct a house for Allen for $10,000. The next day Burns was hit by an auto, seriously injured and thereafter died from those injuries.

(1) Is Burns excused from performance? (2) Explain.

c Allen deposited $100 to Burt's credit in a bank at Burt's direction, in return for Burt's promise to render certain services during the following month. The bank failed, whereupon Burt refused to render the promised service.

(1) What is Allen's remedy? (2) Why?

SURETYSHIP

4 [10]

a Jones was assistant controller of a corporation whose duties consisted of

handling all the funds of a branch office. Smith was the surety. On the death of the treasurer, Jones was promoted to the position of treasurer in charge of all the corporation's finances at the main office. The surety was not informed of Jones's promotion. Jones thereafter defaulted.

(1) Is Smith, the surety, liable for this default? (2) Why?

b Smith was surety on a contractor's bond for the payment of workmen's wages. The contractor defaulted and became bankrupt. Smith paid the wages and filed a claim in the contractor's bankruptcy for priority to which the contractor's workmen would have been entitled.

(1) Is Smith, the surety, entitled to preference? (2) Why?

c A contractor assigned to his surety the amounts due from Carr and all his equipment and materials, the assignment to become effective if the contractor defaulted, and the surety was compelled to complete the work for Carr. The contractor defaulted. The surety completed the contract with Carr and then sold the equipment. The amount received by the surety from Carr and from the sale of the equipment was in excess of the surety's expenditures.

(1) Can the contractor recover this excess? (2) Why?

Agency

5 [10]

a Allen, a traveling salesman for Peters, a New York wholesaler, on his first trip obtains an order for the sale of goods to Thomas which he sends to Peters, who accepts the order and sends the goods to Thomas. On his second trip Allen again calls on Thomas who pays Allen the amount payable for goods previously sold.

(1) Has Allen authority to collect or receive such payment? (2) Explain.

b Asa is employed as bookkeeper and paymaster in the office of Paul's factory. A bill is presented for payment at a time when there is not sufficient money on hand to pay it. Without consulting Paul, who can be reached only with considerable difficulty, Asa borrows money in Paul's name at the bank.

(1) Was Asa's act authorized by reason of his position? (2) Explain.

c Patrick directs John, his agent, to purchase for him 10 shares of the X Company at $100 a share. John, having such shares on hand and being unable to obtain them elsewhere, conveys 10 shares of the X Company to Patrick. On receiving notice from John, Patrick rescinds the transaction. The stock in the meantime declined 10 points.

(1) Can Patrick rescind the transaction? (2) Explain.

Group II—Answer five questions from this group.

Trusts

6 [10]

a Jones deposits $1,000 of his own money in a savings bank and directs that the account be made out "Jones in trust for Allen" but reserves the right to withdraw any part of the deposit at any time for his own use. Thereafter, he tells Allen, his nephew, about the account. Jones dies intestate. The administrator of his estate and Allen both claim the funds in this bank account.

(1) Who is entitled to these funds? (2) Why?

b A corporation kept two bank accounts, one to pay wages of its employees which was designated "Special Trust Account," and the other for all other purposes. The treasurer, acting in accordance with the resolutions of the directors, on each pay day deposited in this "Special Trust Account" a sum sufficient to meet the total pay roll and then drew and delivered to each employee that day a check for his respective pay. At a time when there was about $10,000 in this account and checks for that amount outstanding, the corporation became insolvent and was placed in the hands of a receiver.

(1) Who is entitled to the $10,000 credit in this account, the receiver or the employees? (2) Why?

Bailments (Warehousing)

7 [10]

a A public warehouseman issued warehouse receipts, setting forth the liens thereon as required by law, to the owner of whiskey stored in the warehouse. The warehouseman became bankrupt. Thereafter, the warehouse was sold to another operator at a judicial sale free of all liens against the former warehouseman.

(1) Can the purchaser claim a lien for charges other than those enumerated on the outstanding warehouse receipts issued by the former operator? (2) Why?

b A cotton warehouseman issued receipts on which was conspicuously printed the word "Negotiable" and which also contained a clause in clear print reciting that the cotton was accepted for storage for only one year from date thereof. A holder purchased the receipts for value supposing them to be negotiable.

(1) Are such warehouse receipts negotiable? (2) As to the warehouseman, does this time clause impair the negotiability of the warehouse receipt? (3) Why?

Bankruptcy

8 [10]

a An insolvent debtor makes a voluntary assignment for the benefit of his creditors.

(1) What is the effect, if any, in relation to bankruptcy of the debtor and is there any limitation as to time?

(2) In the event of bankruptcy of the debtor after making such an assignment.

(*a*) What is the status of the assignment?
(*b*) What becomes of the assigned property?

b (1) Who may become a voluntary bankrupt?

(2) May a voluntary bankrupt, after discharge, file a new petition? Explain as to time.

9 Write the letters *a*, *b*, *c*, *d* and *e* in a column and opposite *each* letter write the number preceding the alternative that correctly completes the corresponding statement. [10]

Contracts

a Where an offer in contract is made by mail, the acceptance is legally effective (1) when the offeree dictates and signs the letter of acceptance, (2) when the offeree deposits his letter of acceptance in the post office or mail box, (3) when the offeror receives the letter of acceptance, (4) when the offeror reads the letter of acceptance, (5) at some other time.

b As a general rule a promise in contract results in a legal duty to perform because (1) the promise is part of an agreement, (2) the promisor is morally obligated to perform, (3) there was a consideration for the promise, (4) the promise was in writing, (5) of some other reason.

Sales

c In the case of an unconditional contract to sell specific goods in a deliverable state, where there is no provision as to when title is to pass, (1) title passes when the contract is made, (2) title passes when the goods are delivered, (3) title passes when the buyer indicates that the goods are satisfactory, (4) title passes when the buyer pays for the goods, (5) title passes at some other time.

Suretyship

d A surety who has discharged the principal debtor's obligation is entitled to any collateral held by the creditor, because (1) the surety has a right of indemnity, (2) the surety has a right of contribution, (3) the surety has a right of subrogation, (4) the surety has a right of exoneration, (5) of some other reason.

NEGOTIABLE INSTRUMENTS

e Where X, the holder of a negotiable instrument, desires to transfer it to Y, so that Y can collect the proceeds for him, X should (1) indorse in blank, (2) make a special indorsement, (3) make a restrictive indorsement, (4) make a qualified indorsement, (5) make a conditonal indorsement, (6) indorse in some other way, (7) not indorse.

10 Write the letters *a*, *b*, *c*, *d* and *e* in a column and opposite *each* letter write the number preceding the alternative that correctly completes the corresponding statement. [10]

PARTNERSHIPS

a In the absence of an agreement as to how losses shall be divided among the partners, (1) losses are divided in proportion to capital contributed, (2) losses are divided in proportion to services rendered, (3) losses are divided equally, (4) losses are divided in the ratio for sharing profits, (5) losses are divided in some other way.

b On January 1, 1949, D is "admitted" as a partner in the long-established firm of A, B and C. Therefore, (1) D is responsible for all partnership debts of the firm whether incurred before or after Jan. 1, 1949, (2) D is responsible only for partnership debts incurred after Jan. 1, 1949, (3) D is responsible for all partnership debts except that debts incurred prior to Jan. 1, 1949, can be satisfied only out of partnership property, (4) D is responsible in some other way.

CORPORATIONS

c In connection with dividends payable in cash a corporate liability arises (1) when the passage of the dividend resolution is announced at the end of the meeting, (2) on the "record" date set forth in the resolution, (3) on the "payment" date set forth in the resolution.

d A State statute provides that a corporation may acquire its own shares by purchase only when its net assets exceed its legal capital, and only to the extent of such excess. Where a corporation properly acquires some of its own shares (1) the shares acquired, at the purchase price, should be shown as an asset, (2) the purchase price should be used to reduce the amount of capital stock, (3) the purchase price should be used to reduce the total of capital stock and surplus (retained earnings), (4) the purchase price should be used to reduce surplus, (5) the purchase price should be accounted for in some other way.

NEGOTIABLE INSTRUMENTS

e A promissory note contains a promise to pay $100, (1) with interest, (2) in stated installments, (3) with a provision that upon default in the payment of an installment the entire balance shall immediately come due, (4) with exchange, (5) with an attorney's fee for collection if not paid at maturity.

This note does not contain a promise to pay a "sum certain in money" because

(1) it is payable with interest, (2) it is payable in installments, (3) it contains an acceleration clause, (4) it is payable with exchange, (5) of the provision for an attorney's fees, (6) it is payable in pounds, (7) it does contain a promise to pay a "sum certain".

11 List the numbers (1) to (10) in a column and opposite *each* number write *True* if the corresponding statement is true or *False* if the statement is *not* true. No comments are necessary. Answer *all* parts. A penalty will be imposed for omissions. [10]

(1) In a contract, consideration must be adequate in order to be valid.

(2) In a contract, consideration is benefit to the promisor.

(3) A contract to do what one is already under contract with a third person to do can never be consideration.

(4) A promise can not be sued on unless made to the plaintiff.

(5) An infant may be an agent.

(6) An infant may be a principal.

(7) An agent can not do for a principal acts that he could not do for himself.

(8) Things not yet in existence may be the subject of a contract to sell.

(9) An installment buyer gets no title until he pays in full.

(10) A statement of opinion may be a warranty.

12 List the numbers (1) to (10) in a column and opposite *each* number write *True* if the corresponding statement is true or *False* if the statement is *not* true. No comments are necessary. Answer *all* parts. A penalty will be imposed for omissions. The statements relate to Federal taxes. [10]

(1) An exemption of as much as $1,800 can be obtained for a dependent—$600 for regular exemption, $600 for old age, and $600 for blindness.

(2) An exchange of one personal residence for another can not result in taxable gain.

(3) A nonbusiness bad debt is fully deductible in the same manner as a business bad debt.

(4) Damage to a personal residence due to the bursting of the heating furnace is deductible.

(5) A corporation realizes no gain or loss on the distribution of its assets in a complete liquidation.

(6) If a corporation issues bonds at a premium, the premium is taxable gain in the year the bonds are sold.

(7) A preferred stockholder's entire stockholdings are redeemed plus declared accumulated dividends. The dividends are taxed as ordinary income.

(8) A transfer tax is due on all bonds, debentures or certificates of indebtedness issued by corporations or individuals.

(9) If partnership assets are distributed in kind, the holding period for the partner includes the period during which the assets were held by the partnership.

(10) An owner of an apartment house occupies a suite in the house. He sells the house with the proviso that he is to live there rent-free. The rental value of the suite is income to him each year.

AUDITING

Friday, May 20, 1949 — 1.30 to 5 p. m., only

Answer the questions as directed under each group.

Group I—The candidate must answer all questions in this group.

1 [8]

a In examining securities, give a reason for listing the serial or certificate number of the securities.

b In connection with verification of cash and cash transactions, what purpose is served by examining the endorsements on paid checks?

2 You are making an audit of a client where the records have been found to be inaccurate and where no satisfactory internal control exists. In connection with the audit you are reconciling the cash transactions for the month of December 1948 in addition to the cash and bank balances as of December 31, 1948. You have determined that the client's reconciliation as of November 30, 1948, is correct.

The following information is available to you:

Client's Reconciliation — November 30, 1948

Cash per general ledger	$ 2,631.74
Less—Cash on hand	210.89
	$ 2,420.85
Less—bank service charge for November	9.00
	$ 2,411.85
Add—Outstanding checks	991.00
Balance per bank	$ 3,402.85

Cash Receipts Book for December

December	1	Balance from 11/30	$ 2,631.74
	1	Received on Accounts	403.25
	2	" " "	1,366.40
	3	" " "	974.86
	4	" " "	4,322.47
	5	" " "	5,201.89
	7	" " "	7,310.75
	8	" " "	6,195.18
	9	" " "	8,884.46
	10	" " "	10,227.55
	11	" " "	6,698.89
	12	" " "	210.20
	14	" " "	1,426.46
	16	" " "	400.00
	17	" " "	700.00
	18	" " "	2,709.82
	21	" " "	850.00
	23	" " "	1,100.00
	27	" " "	911.35
	29	" " "	3,875.50
			$65,300.77

Cash Payment Record for December

December	1	Nov. Service charge	$ 9.00
	3	Checks	5,236.50
	5	"	3,645.21
	8	"	16,394.89
	10	"	15,873.42
	12	"	3,123.47
	14	"	475.42
	17	"	1,250.00
	19	"	3,622.83
	22	"	3,692.09
	26	"	3,456.45
	31	"	4,201.25
		Balance December 31	4,311.24
			$65,300.77

Cash on hand December 31 amounted to $100.00. The transactions per the December bank statement, which are correctly recorded by the bank, show that deposits amounted to $62,870.92; checks paid amounted to $57,952.03; service charges for the month were $10.00; and a charge of $100.00 was made against the account because of the return unpaid of a customer's check. Neither the service charges nor the returned check were recorded on the client's books. The total of outstanding checks as of December 31 was found to amount to $4,110.50.

Prepare appropriate working papers, together with any explanations you consider necessary, based on the data given herein. [20]

3 Describe *five* methods that may be employed in the abstraction of (and failure to account for) cash receipts in a company that makes both cash and charge sales.

For *each* of the above methods, state the internal control procedures you would recommend in order to prevent the fraud and the audit procedures you would employ to discover the fraud. Your internal control recommendations should not be predicated upon the existence of controls other than those which you specifically mention in your answer. [10]

4 Describe *five* methods that may be employed in the making of fraudulent disbursements.

For *each* of the above methods, state the internal control procedures you would recommend in order to prevent the fraud and the audit procedures you would employ to discover the fraud. Your internal control recommendations should not be predicated upon the existence of controls other than those you specifically mention in your aswer. [10]

5 A manufacturing company, whose records you are auditing, has $1,000,000 of Buildings and $3,000,000 of Machinery on its books. During the year you are covering in your audit, additions amounted to $100,000 for Buildings and $500,000 for Machinery. All additions were made through construction orders controlled by a Construction Work in Progress account which had a balance of $20,000 at the close of last year and $55,000 at the close of this year. Some of the additions were purchased and a number were constructed by the company. You are to state in detail the audit procedure you

would follow in verification of the fixed asset additions during the year. You may assume that your firm made the audit for the prior year. [15]

6 In making an annual audit, state the general principles or factors you would consider in determining the extent of a test or sampling verification. [7]

Group II—The candidate should select questions in this group having a total valuation of 30 points and submit answers to only those questions.

7 State briefly, using an outline form, the principal purposes of preparing and preserving audit working papers. [10]

8 [20] A company manufactures a product called MZ which is in process for 30 days. Its ingredients are a variety of materials which are introduced into the production vats at established intervals. The resultant finished product is a liquid which at the completion of the process is drawn off into 100-gallon drums. Of the book value of the company's entire inventory, approximately 20 per cent is material, 75 per cent work in process and 5 per cent finished product, all carried at "cost."

The company's records show that work in process is charged with materials put into process at cost, computed on the FIFO basis and that a flat charge per vat is made monthly to cover all other manufacturing costs which are incurred uniformly during the production period. Finished product is charged and work in process credited with the value of the liquid withdrawn at a standard cost per gallon. The company operates 90 vats, production in which is so staggered that approximately the same number of vats can be emptied each day. The company has not made any computations to support the amount as shown in the work in process account.

a State what detail records you would expect the company to maintain for controlling and costing this production process.

b Outline a procedure for verifying the book value of the work-in-process inventory at the close of the company's fiscal year, excluding any consideration of physical inventory taking.

c Either prepare an illustration of a worksheet or list the worksheet headings that you would use for assembling the principal data to be obtained for your verification.

9 [10] Prepare a questionnaire to be used by assistants on auditing engagements to determine whether or not the client's system of internal check is satisfactory with respect to (*a*) loans payable, (*b*) purchases and the relative disbursements.

10 How far is an auditor entitled to probe into matters beyond, or before, the period which he is engaged to audit, and for what purpose, if any, should he do so? [10]

PRACTICAL ACCOUNTING—Part I

Wednesday, May 18, 1949 — 1.30 to 6 p. m., only

Solve all problems.

1 The following condensed balance sheets of the A Company, B Company and C Company were prepared as of December 31, 1948:

Item	*Company A*	*Company B*	*Company C*
Current assets	$1,234,567	$ 731,282	$340,274
Investments:			
80% of B stock, at cost	1,400,000	....	....
75% of C stock, at cost	....	540,200	....
Fixed assets—net	3,030,933	1,322,607	514,987
Total	$5,665,500	$2,594,089	$855,261
Current liabilities	$ 400,500	$ 275,389	$ 93,261
Bonds payable	....	750,000	....
Surplus reserve for redemption of bonds	....	250,000	....
Common stock, $100 par value	3,000,000	1,000,000	600,000
Capital surplus	710,300	....	45,600
Earned surplus	1,554,700	318,700	116,400
Total	$5,665,500	$2,594,089	$855,261

The stock of Company C was acquired by Company B on January 31, 1947. Since that date Company C has had total earnings of $28,400 and paid cash dividends of $40,000. Company B has credited all dividends received to its income account.

Company A acquired the stock of Company B on December 31, 1948.

You are to prepare the journal entries necessary for the preparation of a consolidated balance sheet of Company A and subsidiaries as of the close of business December 31, 1948. Show all supporting computations in good form. [10]

2 [20] The Robert Sherburn Company issued $3,000,000 of 4% first-mortgage bonds on September 30, 1940, at 96 and accrued interest. The bonds were dated June 30, 1940; interest payable semi-annually; redeemable after June 30, 1945, and to June 30, 1947, at 104, and thereafter until maturity at 102; and convertible into $100 par value common stock as follows:

Until June 30, 1945, at the rate of 6 shares for each $1,000 of bonds.

From July 1, 1945, to June 30, 1948, at the rate of 5 shares for each $1,000 of bonds.

After June 30, 1948, at the rate of 4 shares of each $1,000 of bonds.

Expenses of issue were $6,360 which is to be combined with the premium or discount and the total is to be amortized over the life of the bonds from date of issue. The bonds mature in ten years from their date. The company adjusts its books monthly and closes as of December 31 each year.

The following transactions occur in connection with the bonds:

a July 1, 1946—$500,000 of bonds were converted into stock.

b December 30, 1947—$500,000 face amount of bonds were reacquired by purchase on the market at 99¼ and accrued interest. These were immediately retired.

c June 30, 1948—The remaining bonds were called for redemption. For the purpose of obtaining funds for redemption and business expansion, a $4,000,000 issue of 2¾% bonds were sold at 98¾. These bonds were dated June 30, 1948, and were due in 20 years.

You are to prepare in journal form the entries necessary for the company in connection with the above transactions, including monthly adjustments where appropriate, as of each of the following dates:

(1) September 30, 1940

(2) December 31, 1940

(3) July 1, 1946

(4) December 30, 1947

(5) June 30, 1948.

3 The Modern Restaurant, an individual proprietorship, keeps no accounting records except a check book. You are engaged to prepare financial statements for the month of January, 1949, reflecting the operating results and financial position as completely as possible. However, for the purpose of this problem, a complete worksheet may be submitted in lieu of financial statements if appropriate columns are provided for Income and Expense, Capital Account and Balance Sheet. [15]

Your analysis of the checkbook reveals the following:

Balance January 1, 1949		$1,016.52
Receipts:		
Meals	$4,112.30	
Catering services	190.00	
Candy, tobacco, etc.	123.45	
Miscellaneous	8.25	4,434.00
		$5,450.52
Disbursements:		
Employees' salaries (less income tax withheld mounting to $81.00 and Federal Old-Age Benefit Tax)	$ 909.00	
Food, tobacco, candy, etc.	2,847.50	
Rent	125.00	
Gas, electricity and water	106.00	
Laundry	45.50	
Tables and chairs	350.00	
Printing	23.25	
Owner's salary	250.00	
Annual license	100.00	
Social Security taxes (O.A.B. and Unemployment)	117.00	
Income tax withheld	232.50	5,105.75
Balance—January 31, 1949		$ 344.77

Your reconciliation of the bank account as of January 31, 1949, shows:

Balance per bank		$ 625.77
Deduct—Outstanding checks	$ 271.00	
Error occurring prior to Jan. 1949	18.00	289.00
		$ 336.77
Add—Bank service charges:		
For December, 1948	$ 4.08	
For January, 1949	3.92	8.00
Balance per books		$ 344.77

The balance sheet which your client had as of December 31, 1948, was as follows:

Assets		
Cash		$1,016.52
Furniture & fixtures	$2,025.00	
Less—Reserve for depreciation	202.50	1,822.50
		$2,839.02
Liabilities		
Accounts Payable—food purchases		$ 510.25
Accrued 1948 Personal Property Taxes—estimated		24.00
Accrued 1948 O.A.B. and Unemployment taxes		117.00
Income Taxes withheld		232.50
Accrued 1948 annual license		100.00
Proprietor's capital		1,855.27
		$2,839.02

Your investigation reveals that Accounts Payable should have been $81.50 larger than stated on December 31, 1948, and that as of January 31, 1949, they amount to $703.50. You also discover that as of January 31, 1949, there is a receivable for catering service amounting to $75.00. There is an inventory of tobacco and candy at January 31, 1949, of $130.00. The proprietor has no record of the inventory as of December 31, 1948, but is of the opinion that it was about $75.00. He expects to take monthly inventory hereafter.

You find that the business was opened on January 1, 1948, and that all of the December 31, 1948, balance of furniture and fixtures was purchased at that time.

4 The following questions all deal with Federal Income-Tax Regulations. You are to write down the subnumbers in a column and opposite each number you are to give the answer. You need not state the question, nor need you furnish any supporting computations. [5]

a Jones owns and operates a small business as an individual proprietor. During the taxable year he had the following transactions as to each of which you are to state (*a*) the amount of recognized gain or loss and (*b*) the tax basis of the new asset:

(1) He exchanged a machine having an adjusted basis of $2,000 for a similar machine worth $1,500 and received $300 in cash.

(2) He exchanged a pleasure car for which he had paid $1,050 and gave $1,200 cash for a new pleasure car listed at $1,800. The old car had a cash sale value of $900 at the time of the exchange.

(3) He exchanged a machine having an adjusted basis of $2,500 and a fair market value of $3,500 for a similar machine having a fair market value of $3,500.

(4) He had a machine destroyed by fire. He collected $7,000 insurance and immediately purchased a similar machine for $8,000. The machine destroyed had an adjusted basis of $6,500.

(5) He sold for $3,000 a machine which had an adjusted basis of $5,000 and immediately purchased a similar machine, using the proceeds of the sale and $5,000 additional cash.

b List the numbers (1) to (10) and opposite *each* number answer *Yes* or *No* to the corresponding question. Are the following items generally deductible?

(1) Fee paid to an employment agency to obtain a position?

(2) A contribution made to a needy family in your neighborhood?

(3) Taxes paid on personal property not used in your business?

(4) Taxes on income levied by a state?
(5) Interest paid on a mortgage on your residence?
(6) Fee paid to take the C. P. A. examination?
(7) Expenses incurred by a candidate for election to public office?
(8) Organization expenses of a corporation?
(9) Dues paid to a labor union for carrying on the union's labor activities?
(10) Old-age Benefit tax withheld from your pay by your employer?

PRACTICAL ACCOUNTING—Part II

Thursday, May 19, 1949—1.30 to 6 p. m., only

Solve problems 1 and 2 and either problem 3 or problem 4.

1 The Rheta Rose Manufacturing Company produces an item which it sells direct to consumers under its own brand. The item sells at $12.50 per unit, which is a long-established price. Due to a general decline in business activity, sales are currently being made at the rate of 5,000 units per month which is only 40% of the normal productive capacity of the plant of the company.

An analysis of the costs of the company for a recent month, during which only 4,000 units were produced and 5,000 units sold, shows the following:

Manufacturing Costs

Direct labor	$ 9,900.00
Superintendent's salary	1,000.00
Assistant superintendent's salary	750.00
Power purchased	560.00
Direct materials	4,000.00
Purchased parts	2,400.00
Depreciation of building	1,420.00
Maintenance of building	206.00
Heat and light	348.00
Indirect labor	2,240.00
Miscellaneous supplies	800.00
Depreciation of machinery	3,640.00
Repairs to machinery	480.00
Property taxes	600.00
Insurance (fire)	80.00
Social security taxes	456.00
Miscellaneous	1,120.00
	$30,000.00

Selling Costs

Manager's salary	$ 833.33
Salesmen's commissions	18,750.00
Travel	247.05
Advertising	500.00
Clerical salaries	300.00
Packing and shipping	2,108.43
Miscellaneous	1,203.79
	$23,942.60

Administrative and General Costs

Officers' salaries	$1,525.00
Office salaries	975.50
Telephone and telegraph	217.73
Supplies	486.21
Bad debts	625.00
Miscellaneous	392.86
	$4,222.30

An offer has been received from a chain store by the treasurer of the company to purchase 5,000 units a month of the products with only immaterial modifications, to be shipped and billed to the individual stores. The items would be sold under the store's label and would be packed and shipped as directed by the chain at their expense. They offer $7.00 per unit unpacked on the basis of a one-year contract. The management of the Rheta Rose Company does not expect that there will be an improvement in the business within the next year, and there is no fear that the sale of the items to the chain would reduce the present volume of sales to consumers. The company does not believe it can afford to accept the offer as it is losing on its present price of $12.50; therefore, it appears that losses would be substantially increased by entering into the sales contract with the chain.

The treasurer calls you in to prepare an analysis which will show the result of accepting the order in comparison with the result if the order is not accepted. In preparing your analysis you are to assume that all items of cost are either completely fixed or completely variable depending upon the usual dominant characteristic of each item and the data given herein. [18]

2 The operations of a department of a retail store which uses the "Retail Method" of inventory determination are given in the figures presented below. You are to set up in good form a computation showing the ending inventory at sales price and at cost as determined by the "Retail Method." [7]

Opening inventory—cost	$14,250
Opening inventory—sales price	19.105
Purchases—cost	33,771
Purchases—Sales price	46,312
Purchase allowances	1,093
Freight—in	845
Departmental transfers (debit)—cost	100
Departmental transfers (debit)—sales price	140
Additional markups	1,207
Markup cancellations	274
Inventory shortage—sales price	704
Sales (including sales of $4,460 of items which were marked down from $5,920)	37,246

3 [25] You have been called in by a member of the board of directors of the Fayetteville Company for advice in connection with a proposed plan of reorganization. He provides you with the information that follows, and asks that (*a*) you prepare a statement in good form as it might be expected to appear in a balance sheet prepared for publication showing the capital and surplus of the company as of December 31, 1947; (*b*) you prepare a statement showing the condition as it would exist on January 1, 1948, if the reorganization plan were made effective as of that date; and (*c*) you prepare a statement showing the amount of earnings per share of common stock in 1947 if the proposed plan could have been in effect as of January 1, 1947.

The Fayetteville Company is a manufacturer of machine tools. Its business has shown wide fluctuations and there have been corresponding variations in profits. For a number of years prior to 1946 there had not been any significant average earnings; however, for the year 1946 there was a net profit of $942,100. As of December 31, 1946, the following statement was prepared:

$3 Cumulative preferred stock, $50 par value—Outstanding 96,200 shares (Dividends in arrears since September 30, 1930)		$4,810,000
Common stock, no-par, outstanding 120,000 shares at assigned value of..		3,365,473
Earned deficit 1/1/46	(1,174,280)	
Profit for 1946	942,100	(232,180)
Total		$7,943,293

( ) *denotes red figure*

A plan of capital adjustment had been worked out during 1946 which was ratified by the stockholders and made effective as of January 1, 1947. This plan provided that the $3 preferred was to be reduced from $50 par value to $40 par value; that it continue to be preferred for $3 per share dividends on a cumulative basis and that it be preferred in liquidation at $50 per share and redeemable at the option of the company at $55 per share. In settlement of dividends in arrears, the company paid $360.750 cash and issued 216,450 shares of "B" stock having a par value of $10 per share. The "B" shares are nonvoting and are not entitled to dividends. They are redeemable at $20 per share and entitled to $20 per share after preferred but prior to common in liquidation. The agreement under which they are issued provides that a cash redemption fund shall be set

up equal to 50% of the yearly net profits in excess of dividend requirements on preferred stock. The fund is to be used to purchase and retire "B" stock. "Tenders" are to be obtained from stockholders, the lowest being accepted. If no tenders are received within three months after January 1 of each year, the shares to be retired are to be determined by lot. The provisions of issue also state that as long as any "B" stock is outstanding, no dividends may be paid on common stock. The assigned value of common was also reduced to $600,000.

The surplus created by this restatement of stock was treated in accordance with accepted accounting practice. All stockholders accepted the exchange offer.

The operations for the year 1947 resulted in a net profit, after taxes, of $1,631,316. Dividends for the full year were paid on the preferred stock.

It now appears that operations are going to be profitable for an indefinite period and the board of directors desires to work out a plan whereby common stock can be put on a dividend basis. Preferred is currently selling for $52 per share and "B" stock for $9.50 per share.

Based on these values, a plan is under consideration by the board of directors, which it is hoped will enable them to place common on a dividend basis if good earnings continue. This plan calls for authorizing a 5% debenture issue which will be offered to the preferred stockholders in exchange for their stock at the rate of $100 of debentures and 2 shares of common for each two shares of preferred. It is anticipated that the common will be put on a $1 annual dividend basis after the capital adjustments proposed. Holders of "B" stock are to be offered one share of new 6% preferred which is to be issued having $100 par value, and five shares of common for each 10 shares of "B" stock, all before use of the retirement fund.

4 The City of Patwray voted a bond issue for the purpose of constructing a modern sewer system in a section of the city. The cost is to be borne 10% by general revenues of the city and 90% by assessment against the property in the area of the improvement.

You are to prepare a balance sheet of the fund as of the close of the fiscal year of the city, December 31, 1948. [25]

The following transactions are to be considered:

February 1, 1948—The city engineer submits to city council an estimate of the cost of the project showing a total of $455,000. The council approves the estimate and project, subject to voter approval of the necessary bond issue.

April 1, 1948—A ten-year 4% bond issue of $460,000 was approved by the voters of the city, the proceeds to be used for the project.

April 10, 1948—A contract for $15,000 covering preliminary planning was entered into by the trustees who are carrying out the project.

April 15, 1948—The assessment roll is certified on the basis of $415,000 due in ten equal annual installments starting with May 1, 1949. Interest at 4% per annum from May 1, 1948, is to be paid on each installment due date, based on the total assessment outstanding.

April 30, 1948—The preliminary plans are completed and an invoice of $13,700 is received from the contractor in full payment. The trustees borrow $25,000 from the general fund of the city to pay this and other costs. The invoice was paid on May 5, 1948.

May 20, 1948—A contract for construction was entered into at a price of $420,000, subject to some possible future adjustments.

June 1, 1948—$200,000 of the authorized bonds were sold at 101. The entire issue is to be dated June 1, 1948, with interest payable December 1 and June 1 each year. The bonds mature at the rate of $46,000 per year starting June 1, 1949.

July 31, 1948—A partial payment of $26,100 was made to the contractor, which amount was 90% of the amount due based on percentage of completion. The loan from the general fund was repaid.

November 1, 1948—The remaining bonds were sold at 98 and accrued interest.

August 1, 1948, to December 31, 1948—Payments to the contractor amounted to $284,400, 10% of the amount due having been withheld pending completion. $4,210 of costs in connection with administering the construction project were paid during the period. The bond interest was paid at due date. The city paid $2,300 on its part of the cost of the project.

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